

85-599-CFX  
Status: GRANTED

Title: United States, Petitioner  
v.  
American Bar Endowment, et al.

cketed:  
tober 7, 1985

Court: United States Court of Appeals for  
the Federal Circuit

Counsel for petitioner: Solicitor General

Counsel for respondent: Gregory Jr., Francis M.

EDITOR'S NOTE

THE FOLLOWING PAGES WERE POOR HARD COPY  
AT THE TIME OF FILMING. IF AND WHEN A  
BETTER COPY CAN BE OBTAINED, A NEW FICHE  
WILL BE ISSUED.

try	Date	Note	Proceedings and Orders
1	Jul 29 1985		Application for extension of time to file petition and order granting same until October 7, 1985 (Chief Justice, July 31, 1985).
2	Oct 7 1985	G	Petition for writ of certiorari filed.
3	Nov 6 1985		DISTRIBUTED. November 27, 1985
4	Nov 7 1985	X	Brief of respondents American Bar Endowment, et al. in opposition filed.
5	Dec 2 1985		Petition GRANTED. Justice Powell and Justice O'Connor OUT. *****
6	Nov 26 1985	X	Reply brief of petitioner United States filed.
8	Jan 13 1986		Order extending time to file brief of petitioner on the merits until January 31, 1986.
9	Jan 31 1986		Order further extending time to file brief of petitioner on the merits until February 7, 1986.
0	Feb 10 1986		Brief of petitioner United States filed.
1	Feb 10 1986		Record filed.
2	Feb 10 1986		Certified copy of original record received, 12 large brown envelopes, 11 & 12 under seal.
3	Feb 14 1986		Joint appendix filed.
4	Feb 13 1986		Record filed.
5	Feb 13 1986		Certified copy of original briefs and joint appendix received.
7	Mar 3 1986		Order extending time to file brief of respondent on the merits until March 28, 1986.
8	Mar 14 1986		SET FOR ARGUMENT, Monday, April 28, 1986. (4th case)
9	Mar 10 1986	G	Motion of California Farm Bureau Federation for leave to file a brief as amicus curiae filed.
10	Mar 31 1986		Motion of California Farm Bureau Federation for leave to file a brief as amicus curiae GRANTED. Justice Powell and Justice O'Connor OUT.
11	Mar 28 1986		Brief of respondents AM Bar Endowment, et al. filed.
12	Mar 31 1986		CIRCULATED.
13	Apr 21 1986	X	Reply brief of petitioner United States filed.
14	Apr 28 1986		ARGUED.



85-599

No.

Supreme Court, U.S.

FILED

OCT 7 1985

JOSEPH T. SPANIOL, JR.  
CLERK

**In the Supreme Court of the United States**

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT

UNITED STATES OF AMERICA, PETITIONER

v.

FREDERIC D. TURNER, ET UX., ET AL.

**PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE FEDERAL CIRCUIT**

CHARLES FRIED

*Acting Solicitor General*

ROGER M. OLSEN

*Acting Assistant Attorney General*

ALBERT G. LAUBER, JR.

*Assistant to the Solicitor General*

ROBERT A. BERNSTEIN

ROBERT S. POMERANCE

*Attorneys*

*Department of Justice*

*Washington, D.C. 20530*

*(202) 633-2217*

**BEST AVAILABLE COPY**

109

## QUESTIONS PRESENTED

1. Whether income derived by a tax-exempt professional organization from the sale of group insurance to its members is "unrelated business income" subject to tax under Sections 511 through 513 of the Internal Revenue Code.

2. Whether an insured member's assignment of his policy dividends to the organization, when the assignment is a requirement of purchasing the insurance, is deductible as a "charitable contribution" under Section 170 of the Code.

## II

### PARTIES TO THE PROCEEDING

In addition to the parties named in the caption, Arthur M. Sherwood (and his wife), Herbert C. Broadfoot II (and his wife), and Frederick G. Boynton are respondents.

## TABLE OF CONTENTS

	Page
Opinions below .....	1
Jurisdiction .....	2
Statutes involved .....	2
Statement .....	2
A. American Bar Endowment .....	2
B. Frederic D. Turner, et ux., et al. ....	7
Reasons for granting the petition .....	11
A. American Bar Endowment .....	12
B. Frederic D. Turner, et ux., et al. ....	22
Conclusion .....	26
Appendix A .....	1a
Appendix B .....	24a
Appendix C .....	25a
Appendix D .....	57a
Appendix E .....	59a

## TABLE OF AUTHORITIES

### Cases:

<i>C.F. Mueller Co. v. Commissioner</i> , 190 F.2d 120....	15, 19
<i>Carolinas Farm &amp; Power Equipment Dealers v. United States</i> , 699 F.2d 167 .....	7, 12, 13
<i>Helvering v. Taylor</i> , 293 U.S. 507 .....	25
<i>Lamont v. Commissioner</i> , 339 F.2d 377 .....	16
<i>Louisiana Credit Union League v. United States</i> , 693 F.2d 525 .....	7, 12, 13
<i>Professional Insurance Agents v. Commissioner</i> , 726 F.2d 1097 .....	7, 12, 13
<i>Roche's Beach, Inc. v. Commissioner</i> , 96 F.2d 776..	15

## IV

## Cases—Continued:

## Page

<i>Rockwell v. Commissioner</i> , 512 F.2d 882 .....	25
<i>Sedam v. United States</i> , 518 F.2d 242 .....	22, 24
<i>Singer Co. v. United States</i> , 449 F.2d 413 .....	23
<i>Stubbs v. United States</i> , 428 F.2d 885 .....	23
<i>United States v. American College of Physicians</i> , cert. granted, No. 84-1737 (July 1, 1985) .....	12, 14, 21, 22
<i>Welch v. Helvering</i> , 290 U.S. 111 .....	25

## Statutes and regulations:

## Internal Revenue Code of 1954 (26 U.S.C.):

§ 162 (a) .....	16
§ 170 .....	22, 23
§ 170 (a) .....	9
§ 170 (c) (2) .....	22
§ 170 (c) (2) (B) .....	9
§ 501 .....	2, 59a
§ 501 (c) .....	2, 7, 14, 15, 60a
§ 501 (c) (3) .....	2, 7, 14, 15, 60a
§ 501 (c) (6) .....	2, 7, 14, 15, 60a
§ 502 (a) .....	15, 62a
§ 511 .....	2, 62a
§§ 511-513 .....	4
§§ 511-515 .....	16
§ 512 .....	2, 63a
§ 512 (a) .....	5, 63a
§ 512 (a) (1) .....	16, 63a
§ 513 .....	2, 66a
§ 513 (a) .....	5, 66a
§ 513 (c) .....	5, 6, 12, 13, 14, 15, 17, 18, 67a

Revenue Act of 1950, ch. 994, 64 Stat. 906 *et seq.*... 15

Tax Reform Act of 1969, Pub. L. No. 91-172, 83

Stat. 487 *et seq.* ..... 17

## Treas. Reg. (26 C.F.R.):

§ 1.501 (c) (6) -1 .....	2, 67a
§ 1.513-1 .....	2, 17, 68a
§ 1.513-1 (b) .....	17, 70a

## Miscellaneous:

32 Fed. Reg. 17657 (1967) .....	17
H.R. Rep. 2319, 81st Cong., 2d Sess. (1950) .....	16

## V

## Miscellaneous—Continued:

## Page

H.R. Rep. 1337, 83d Cong., 2d Sess. (1954) .....	22, 24
H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1 (1969) .....	17
Schwarz & Hutton, <i>Recent Developments in Tax- Exempt Organizations</i> , 18 U.S.F.L. Rev. 649 (1984) .....	20
S. Rep. 2375, 81st Cong., 2d Sess. (1950) .....	16
S. Rep. 1622, 83d Cong., 2d Sess (1954) .....	22, 24
S. Rep. 91-552, 91st Cong., 1st Sess. (1969) .....	17



**In the Supreme Court of the United States**

OCTOBER TERM, 1985

---

No.

UNITED STATES OF AMERICA, PETITIONER

*v.*

AMERICAN BAR ENDOWMENT

---

UNITED STATES OF AMERICA, PETITIONER

*v.*

FREDERIC D. TURNER, ET UX., ET AL.

---

**PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE FEDERAL CIRCUIT**

---

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in these cases.

**OPINIONS BELOW**

The opinion of the court of appeals (App., *infra*, 1a-23a) is reported at 761 F.2d 1573. The opinion of the Claims Court (App., *infra*, 25a-58a) is reported at 4 Cl. Ct. 404.

## JURISDICTION

The judgment of the court of appeals (App., *infra*, 24a) was entered on May 10, 1985. On July 31, 1985, the Chief Justice extended the time within which to petition for a writ of certiorari to and including October 7, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATUTES INVOLVED

The relevant portions of Sections 501, 511, 512, and 513 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Sections 1.501(c)(6)-1 and 1.513-1 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out in a statutory appendix (App., *infra*, 59a-76a).

## STATEMENT

These cases were consolidated for trial and decision in the Claims Court and for briefing, argument and decision in the court of appeals. Although the cases are closely linked, they raise different legal issues and are most conveniently discussed separately.

### A. American Bar Endowment

1. The American Bar Endowment is a corporation exempt from tax under Section 501(c)(3) of the Internal Revenue Code.<sup>1</sup> Its main purposes are to advance legal research and to promote the administration of justice. It accomplishes these purposes by making grants to other charitable and educational organizations (App., *infra*, 26a). All members of the American Bar Association (ABA) are members of the Endowment without paying additional dues (C.A. App. 116). The ABA is exempt from tax under Section 501(c)(6) as a "business league."

<sup>1</sup> Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax periods in issue (the Code or I.R.C.).

The Endowment has conducted a group insurance program for ABA members since 1955 (App., *infra*, 27a). The program offers life, health, accident, and disability insurance underwritten by major insurance companies. Coverage for members' dependents is also available under some plans (*ibid.*). The life insurance plan, the most heavily subscribed, had \$2.75 billion of insurance outstanding in 1980. More than 57,000 (or about one-fifth) of the Endowment's members were then enrolled in one or more of the plans (C.A. App. 143).

The Endowment administers its insurance plans with a staff of 40 (App., *infra*, 27a). It actively supports and officially endorses coverage under the plans, and solicits its members' enrollment through aggressive advertising prepared and distributed by its staff (C.A. App. 141, 811, 1248-1268). The staff also performs many tasks essential to the program's day-to-day operation, such as screening members' applications, collecting members' premiums, and forwarding premiums to the underwriters (*id.* at 141-142). Nearly all of the Endowment's operating budget is consumed by these activities (*id.* at 139).

The Endowment's contracts with its underwriters require the latter to calculate and refund to the Endowment annually any policy dividends or retrospective rate credits that accrue to the group policies (C.A. App. 120-122, 128). These sums, which we shall refer to collectively as "dividends," reflect the excess of the premiums paid by ABA members over the underwriters' cost of paying claims and servicing the plans (App., *infra*, 27a-30a). In order to enroll in the program, every insured must waive his claim to receive these dividends and must consent to their retention by the Endowment. This condition is stated on the insurance application forms, and the Endowment insists on its strict enforcement (*id.* at 3a-4a, 32a; C.A. App. 440-442). The Endowment applies the dividends, net of its plan administration expenses, to fund its educational projects. Every

year, it calculates the percentage of the overall premiums that have been thus applied, and advises its insured members that they may, in the opinion of the Endowment's counsel, deduct corresponding portions of their own premiums as tax-deductible charitable contributions (App., *infra*, 4a, 32a-33a; C.A. App. 867-871).

The Endowment's strategy is to maximize the policy dividends and thus maximize its profits. It uses its considerable leverage with the underwriters to tailor the insurance program to that end (App., *infra*, 3a-4a, 27a-30a). Because the plans are experience-rated, and because ABA members enjoy very favorable mortality and morbidity experience, the Endowment could, if it chose, offer insurance at very low premiums, perhaps at premiums approaching the lowest available for group insurance in the country (App., *infra*, 30a-32a). In order to produce the largest dollar volume of policy dividends, however, the Endowment sets the price of its insurance at rates comparable to those charged for other insurance products in the market (App., *infra*, 3a-4a, 27a-30a). The Endowment regularly reviews the market comparability of its prices and benefits and adjusts its premiums from time to time to keep them competitive (*ibid.*). By the same token, the Endowment takes care not to raise its premiums above the market range, for fear of discouraging participation (*ibid.*).

The use of prevailing market rates, coupled with the favorable mortality and morbidity experience of ABA members, has made the Endowment's insurance operations highly profitable. The amounts refunded to it as dividends often exceed 40% of the premiums its members pay (C.A. App. 560-561; App., *infra*, 4a). Income from its insurance operations is by far the major source of its revenue (C.A. App. 1319). The Endowment thus serves successfully as a middleman between its members and commercial vendors of insurance.

2. Sections 511 through 513 of the Internal Revenue Code impose a tax, at regular corporate rates, on the

"unrelated business taxable income" of otherwise tax-exempt organizations like the Endowment. An "unrelated trade or business" is one "the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other [tax-exempt] purpose" (I.R.C. § 513(a)). Section 513 (c) provides that "the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services."

The Endowment's gross policy dividends from its insurance operations during 1979-1981 aggregated almost \$19 million (C.A. App. 129). On audit, the IRS determined that those revenues, less the Endowment's expenses of administering the insurance program, were subject to tax as "unrelated business income" (*id.* at 130, 139). The Commissioner accordingly determined tax deficiencies of approximately \$6 million for the three years (*id.* at 130-132).

The Endowment paid the asserted deficiencies and, following denial of its administrative claims for refund, instituted this refund suit in the Claims Court. It conceded that its insurance operations were "regularly carried on" (I.R.C. § 512(a)). It likewise conceded that the conduct of those operations was "not substantially related" to the performance of its tax-exempt educational functions (I.R.C. § 513(a)). See C.A. App. 144. The Endowment's principal contention was that its insurance operations did not amount to a "trade or business," on the theory that they represented "contributions" that ABA members made "by foregoing the advantage of having premium refunds returned to them" (*id.* at 22-24).

Following a trial, the Claims Court entered judgment for the Endowment. It held that the profits derived by the Endowment from its insurance operations were im-



immune from unrelated business income tax because they did not arise from a "trade or business" within the meaning of Section 513(c). The court believed that its task in interpreting that Section was to "distinguish between those activities that constitute a trade or business and those that are merely fundraising" (App., *infra*, 33a-34a). The controlling test for this purpose, the court concluded, was whether the Endowment conducted its activities in "a competitive, commercial manner" (*id.* at 34a). The court then recited several factors that, "taken together, \* \* \* ma[d]e it impossible \* \* \* to conclude that the [Endowment's] insurance programs were operated" in a commercial or competitive way (*id.* at 40a). The Endowment's insurance program, the court said, was "label[led]" by it and "perceived" by its members as "a fundraising activity." The Endowment's profits, the court stated, were "astounding" and "[could] not be maintained in a competitive market." And "the insurance program," the court observed, "was operated with the approval and consent of the ABA membership." App., *infra*, 32a, 36a-38a. In the court's view, "an enterprise that depends on the consent of its customers for its profits is not operating in a commercial manner and is not a trade or business" (*id.* at 41a).

3. The Court of Appeals for the Federal Circuit affirmed. It concluded that the Claims Court had "properly found facts" and had "applied the correct standard" to determine whether the Endowment's insurance operations were a "trade or business" within the meaning of Section 513(c). See App., *infra*, 9a. Based on "the persistent and fundamental fund-raising motivation" of the Endowment's insurance program, "the knowledgeable approval of and consent to the program by the ABA's members," and the Endowment's "phenomenal success" in accumulating policy dividends, the court of appeals was persuaded that the Endowment's activities were not "competitive" or "commercial" and thus were immune from tax. *Id.* at 8a-9a.

The court of appeals described as "inapposite" (App., *infra*, 10a) decisions of the Fourth, Fifth, and Sixth Circuits holding that profits derived by tax-exempt professional or trade associations from the operation of group insurance plans are subject to unrelated business income tax. See *Professional Insurance Agents v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984); *Carolinas Farm & Power Equipment Dealers v. United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982). In thus reasoning, the Federal Circuit relied principally on the fact that the organizations marketing the insurance in those cases were "[b]usiness leagues" exempt from tax under Section 501(c)(6), rather than charitable or educational associations exempt from tax (as is the Endowment) under Section 501(c)(3). The fact that the Endowment "set out to make as much profit as possible" did not in the court's view determine whether its insurance activities were a "trade or business" (App., *infra*, 11a). "Unlike what some other courts may do," the court of appeals observed, "this court does not find 'profits,' or the maximization of revenue, to be the controlling basis for a determination of whether the unrelated business tax provisions apply" (*ibid.*).

#### B. Frederic D. Turner, et ux., et al.

1. The individual respondents are ABA members who bought insurance from the Endowment (App., *infra*, 31a, 38a).<sup>2</sup> Each agreed, as a condition of enrollment, that the Endowment could keep any dividends apportioned to his policy (*ibid.*). Each knew, when he wrote his premium checks, that the Endowment would use the dividends to further its work in the legal field.

<sup>2</sup> Respondents' wives are parties solely by virtue of having filed joint income tax returns with their husbands for the relevant tax years.



Respondents Turner and Sherwood signed up for life insurance in 1972. They enrolled after reading brochures explaining that the Endowment's insurance program raised money for educational purposes while offering attractive insurance benefits at a reasonable cost (C.A. App. 405-407, 414-415, 1027-1034, 1040-1047). The brochures principally described the "highlights" of the coverage that the Endowment offered for sale, including the option granted to members under 40 (as Turner and Sherwood then were) to be accepted without medical evidence of insurability (*ibid.*).

Respondent Broadfoot initially purchased life insurance in 1971 because, as he testified, "[m]y first child had recently been born and I was interested in obtaining some life insurance" (C.A. App. 388). He regarded the premiums charged as reasonable (*id.* at 402-403). At one time he carried a life policy through the Georgia State Bar but discontinued it after determining that it cost more than the Endowment's (*id.* at 396-399).

Respondent Boynton purchased disability insurance in 1978 (C.A. App. 74). He concluded after reading the Endowment's literature that its disability coverage was "reasonably or competitive[ly] priced" (*id.* at 430). Before applying for his policy, he examined a number of other disability plans. He found that two offered considerably greater benefits than the Endowment's but were more expensive (*id.* at 427, 429).

None of the individual respondents testified that, if given an option, he would have elected to assign his policy dividends to the Endowment. None testified that he chose the Endowment's coverage over a cheaper policy in order to further the Endowment's educational goals, or that he thought the premiums charged by the Endowment exceeded the economic value of the insurance he purchased. Two nonparty insureds, on the other hand, testified that they would have opted to keep their dividends had such an election been afforded (C.A. App. 592-593, 690-691). One testified that he had purchased

insurance from the Endowment because he found its premiums competitive and because he thought that the Endowment "would certainly have the clout to deal with the insurance company" (*id.* at 687-688). The other testified that his sole motive for signing up was to obtain insurance; he had previously held through his state bar association a group life policy that cost more than the Endowment's (C.A. App. 590-593, 596, 784-785).

2. Section 170(a) of the Code provides an income tax deduction for "charitable contribution[s]." Section 170(c)(2)(B) defines a "charitable contribution" as "a contribution or gift" to or for the use of an entity that is "organized and operated exclusively for religious, charitable \* \* \* or educational purposes." None of the individual respondents deducted any part of the insurance premiums that he paid the Endowment as a "charitable contribution" on his tax return for the years at issue (C.A. App. 52-54, 64-66, 76-78, 86-89). Thereafter, respondents were invited, and agreed, to take part in this "test case" mounted by the ABA (*id.* at 409-410, 425). Each filed an administrative claim for refund, claiming a charitable contribution deduction ranging from 28% to 55% of the premiums he had paid. These percentages depended on the year and type of insurance involved, and were derived from notices issued to respondents by the Endowment (*id.* at 391-392, 407-408, 416-418, 423-424, 868-871). Each sought a refund of \$40 or less (*id.* at 52-54, 64-66, 76-78, 86-89).

When the IRS demurred, respondents instituted these refund suits in the Claims Court. They contended that each premium they paid to the Endowment was a "dual payment," representing in part the purchase of insurance and in part a charitable donation (App., *infra*, 48a). The Claims Court, following a trial, entered judgment for the United States. It held that none of the respondents was entitled to a charitable contribution deduction for any portion of his premiums.

The court began by examining the relevant legal standards. In its view, an insured's "mere awareness" that the Endowment's insurance profits would be devoted to charitable purposes "is not sufficient to establish that he made a charitable contribution" (App., *infra*, 52a). Rather, "[t]o establish a dual payment, the taxpayer must demonstrate that he bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise" (*id.* at 49a). Each respondent, in other words, had to show "that an equivalent insurance product was available to him for a lower price and that he bypassed that product because he wished to make a charitable contribution to the Endowment" (*id.* at 52a (footnote omitted)).

Turning to the facts of each case, the Claims Court concluded that none of the respondents had proved that his purchase of insurance from the Endowment reflected anything other than his own economic interest (App., *infra*, 52a-54a). Three of the respondents, the court found, had failed to establish that cheaper insurance was available to them elsewhere (*ibid.*). The fourth, while demonstrating that cheaper insurance existed, offered no proof that he knew about it during the tax years at issue and had elected to buy the Endowment's policy instead (*id.* at 55a). The court noted that the Endowment's advertising was "aggressive" and "in some ways suggested [that its insurance] may be the best deal in the market" (C.A. App. 811). Thus, if an ABA member "did not have the two plans side by side," he might well be unaware that he could have obtained a policy elsewhere for less (*id.* at 811-812).

3. The court of appeals reversed and remanded. It directed the Claims Court to conduct "such further proceedings as are appropriate to determine whether the relationship between the Endowment and the [individual respondents] was predominately of a business nature or whether the transaction did have a substantial charitable component" (App., *infra*, 22a-23a).

The Federal Circuit held that the inquiry conducted by the trial court—whether the respondents could have obtained comparable insurance coverage for less money—was "an incorrect definitization of the proper standard" (App., *infra*, 19a). The Claims Court's approach was wrong, the court of appeals said, because it required affirmative proof of "a charitable motivation of disinterested generosity" (*id.* at 19a-20a). The correct legal test, rather, in the court of appeals' view, was "whether the transaction between the Endowment and the taxpayers \* \* \* was of a business nature and not charitable" based on "all the pertinent circumstances" (*id.* at 21a (original quotation marks omitted)). Such a test, the court opined, "should not be too difficult" for ABA members to pass (*id.* at 22a).

Finding the record "almost completely bare" as to the nature of the insureds' dealings with the Endowment, the court of appeals remanded their cases with instructions. Given "the Endowment's persistent and public efforts to enhance its charitable funds," the court suggested, members who bought insurance from it should be able "to present a *prima facie* case" for a charitable deduction "simply [by] mak[ing] a sworn assertion that they wanted to aid that charitable endeavor and entered the Endowment's plan because it enabled them to do so" (*ibid.*). Under the Federal Circuit's instructions, the government on remand would then have the burden to "controvert that position and [to] suggest factors showing that the transaction was basically business-oriented" (*ibid.*). On July 17, 1985, the court of appeals stayed proceedings on remand pending disposition of this petition.

#### REASONS FOR GRANTING THE PETITION

The court of appeals has decided two important questions of federal tax law in a way that conflicts directly with the decisions of other courts of appeals and with well-established tax principles. The first question pre-



sented is related to that on which this Court recently granted review in *United States v. American College of Physicians*, No. 84-1737 (July 1, 1985), also on certiorari to the Federal Circuit. The second question presented is inextricably bound with the first, involving the effect of the insurance purchase from the buyer's rather than the seller's viewpoint. The questions have considerable administrative importance and potentially involve hundreds of millions of dollars in revenue. Review by this Court is therefore appropriate.

#### A. American Bar Endowment

1. a. The court of appeals' holding concerning the taxability of the Endowment's insurance operations squarely conflicts with recent decisions of the Fourth, Fifth and Sixth Circuits. See *Carolinas Farm & Power Equipment Dealers v. United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *Professional Insurance Agents v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984). The organization involved in each of those cases was a tax-exempt association which, like the Endowment, drew its members exclusively from a single trade or profession. Each operated a group insurance program for its members. Like the Endowment, each selected an insurer to underwrite its program, actively promoted and marketed its group coverage to its members, performed day-to-day tasks of administering the program, and received rebates of the members' premiums from the underwriters. Like the Endowment, each association made sizable profits on its insurance operations, yet contended that they did not constitute a "trade or business" within the meaning of Section 513(c).

In *Louisiana Credit Union League v. United States*, *supra*, the Fifth Circuit squarely rejected that argument (693 F.2d at 531-534). It noted that Section 513(c) defines a "trade or business" to include "any activity which is carried on for the production of income from the sale of goods or the performance of services." Since the asso-

ciation both sold insurance and performed services in administering its plans, and since it "had a profit motive for its activities," the Fifth Circuit held that it was engaged in a "trade or business" and that its insurance profits were thus subject to unrelated business income tax (693 F.2d at 532-534). As the court put it (*id.* at 532):

We believe that the "profit motive" standard is the proper one to be applied in this case, for it is consistent with the plain language of section 513 as well as the accompanying regulations. The statute, which clearly encompasses within its parameters any activity "carried on for the production of income," first raises the issue of motive. The regulations, which invoke section 162 and its "profit motive" gloss, confirm that motive is the key inquiry. Thus, to determine whether a tax-exempt organization is carrying on a trade or business, the court must look to see whether that institution is engaged in extensive activity over a substantial period of time with the intent to earn a profit.

The Fourth and Sixth Circuits, on virtually identical facts, have reached the same conclusion for the same reasons. See *Carolinas Farm & Power Equipment Dealers v. United States*, 699 F.2d at 170 (adopting "profit motive" test); *Professional Insurance Agents v. Commissioner*, 726 F.2d at 1102 (same).

The decision below squarely rejects both the legal standard applied by these courts and the tax result they reached. Whereas the Fourth, Fifth and Sixth Circuits employed a "profit motive" test for determining the existence of a "trade or business" under Section 513(c), the Federal Circuit below declared: "Unlike what some other courts may do, this court does not find 'profits,' or the maximization of revenue, to be the controlling basis for [that] determination" (App., *infra*, 11a). And whereas the Fourth, Fifth and Sixth Circuits have held that insurance profits of exempt organizations are subject to unrelated business income tax, the court below, on substantially identical facts, has ruled such profits tax-free.

b. In finding these conflicting decisions “inapposite,” the Federal Circuit (App., *infra*, 10a), like the Claims Court (*id.* at 25a-26a), relied principally on the fact that the associations marketing the insurance there were organized as “[b]usiness leagues” exempt from tax under Section 501(c)(6), rather than as charitable or educational associations exempt from tax (as is the Endowment) under Section 501(c)(3). This is precisely the same meaningless distinction that the respondent in *United States v. American College of Physicians*, *supra*, urged upon this Court in unsuccessfully opposing certiorari in that case (84-1737 Br. in Opp. 12). The respondent there, like the Endowment, is a professional association tax-exempt under Section 501(c)(3). In an effort to avoid tax on its profits from the publication of commercial advertising, it urged that Treasury Regulations holding such activities to be an “unrelated trade or business” should be construed to apply only to the advertising operations of Section 501(c)(6) groups, and not to identical advertising operations of Section 501(c)(3) groups (84-1737 Br. in Opp. 11-13, 15).

As we have pointed out in greater detail in our briefs in *United States v. American College of Physicians* (84-1737 Reply Br. at 4-8; U.S. Br. at 33-40),<sup>3</sup> the subsection of Section 501(c) under which a professional association happens to be organized makes absolutely no difference in determining the taxability of its profit-motivated activities. The question here is whether the Endowment’s insurance operations are a “trade or business.” Those words are defined in Section 513(c), and that definition applies to *all* tax-exempt organizations, regardless of the particular subsection of Section 501(c)—there are more than twenty—on which they base their tax-exempt status. Under that definition, it is the nature of the activities conducted, not the origin of the exemption, that deter-

<sup>3</sup> We are providing copies of these briefs to counsel for respondents in this case.

mines the taxability of the profits realized. There is, accordingly, no statutory basis for contending that insurance operations conducted by Section 501(c)(6) groups are a “trade or business,” but that the Endowment’s substantially identical insurance operations are not a “trade or business,” simply because the Endowment chose to be organized under Section 501(c)(3). Indeed, such a contention would be particularly strained here, since the Endowment is a Section 501(c)(3) affiliate of the ABA, which is *itself* a Section 501(c)(6) business league. On the court of appeals’ theory, any business league could escape tax on its insurance operations—operations that would be subject to tax under the decisions of the Fourth, Fifth, and Sixth Circuits—simply by spinning off those operations into a Section 501(c)(3) sister corporation. This in effect would make payment of the unrelated business income tax *elective*, a result that Congress would surely find rather surprising.

2. a. In declining to follow the holdings of the Fourth, Fifth and Sixth Circuits, and in rejecting the legal standard those courts adopted, the Federal Circuit has ignored both the express language of Section 513(c) and Congress’s intention in enacting the unrelated business income tax. Before that law was enacted (Revenue Act of 1950, ch. 994, 64 Stat. 906 *et seq.*), charitable organizations that carried on ordinary trades or businesses were able to escape tax on their profits on the theory that the charitable “destination” of the revenues took precedence over their commercial “source.” Thus, a nationwide vendor of macaroni (*C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951)), and a commercial bathing beach facility (*Roche’s Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938)), successfully claimed tax-exempt status simply because their business profits went to charity.

In 1950 Congress responded to this problem in two ways. First, it enacted the so-called “anti-feeder” provision (I.R.C. § 502(a)), under which organizations “op-



erated for the primary purpose of carrying on a trade or business for profit" cannot claim tax exemption solely on the ground that their profits go to charity. Second, Congress enacted the "unrelated business income tax," now codified in Sections 511 through 515 of the Code. Those provisions generally require any organization that otherwise qualifies for tax exemption to pay tax at regular corporate rates on income derived "from any unrelated trade or business \* \* \* regularly carried on by it" (I.R.C. § 512(a)(1)).

The chief impetus behind the new tax was Congress's desire to put the business operations of tax-exempt organizations on an equal footing with those of their tax-paying commercial counterparts. The House report stated that "[t]he problem at which the tax on unrelated business income is directed \* \* \* is primarily that of unfair competition." H.R. Rep. 2319, 81st Cong., 2d Sess. 36 (1950). As amended in 1950, the Code "does not deny [a tax] exemption where the organizations are carrying on unrelated active business enterprises, or require that they dispose of such businesses, but merely imposes the same tax on income derived therefrom as is borne by their competitors" (*id.* at 37).

The unrelated business income tax, as enacted in 1950, did not include a definition of the term "trade or business." The legislative history, however, made clear that the term "has the same meaning as it has elsewhere in the code, as, for example, in [the predecessor of Section 162(a)]," which authorizes deductions for expenses incurred "in carrying on any trade or business." See H.R. Rep. 2319, *supra*, at 109; S. Rep. 2375, 81st Cong., 2d Sess. 106 (1950). Under Section 162(a), "[i]t is well established that the existence of a *genuine profit motive* is the most important criterion for the finding that a given course of activity constitutes a trade or business." *Lamont v. Commissioner*, 339 F.2d 377, 380 (2d Cir. 1964) (emphasis added).

In 1967, the Treasury promulgated regulations defining a "trade or business" for purposes of the unrelated business income tax. Treas. Reg. § 1.513-1, 32 Fed. Reg. 17657 (1967). The regulations explained that any activity "which is carried on for the production of income and which otherwise possesses the characteristics required to constitute [a] 'trade or business' within the meaning of section 162 \* \* \* presents sufficient likelihood of unfair competition to be within the policy of the [unrelated business income] tax" (Treas. Reg. § 1.513-1(b)). "Accordingly," the Treasury concluded, "for purposes of section 513 the term 'trade or business' has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services" (*ibid.*).

In an effort to resolve the controversy spawned by these regulations, Congress in 1969 codified the Treasury's definition of "trade or business" (Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 *et seq.*). Congress explicitly stated its intention "to make clear that such regulations are valid" and its determination that they "should be placed in the tax laws." H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1, at 44 (1969); S. Rep. 91-552, 91st Cong., 1st Sess. 75 (1969). Effectuating that aim, Congress in 1969 added to the Code a new Section 513(c). It provides that, "[f]or purposes of this section, the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services."

b. The unalloyed language of Section 513(c) makes plain the error of the Federal Circuit. The Endowment's insurance operations obviously comprised both "the sale of goods" and "the performance of services." It sold various insurance products at retail, and it performed valuable services by putting together a group of above-average insureds, negotiating with underwriters, assembling a package of group policies, marketing that package to its members, collecting its members' pre-

miums, and discharging countless other day-to-day administrative tasks. Indeed, its staff of 40 ran the business in much the same way that most insurance brokers, plan administrators, and other financial intermediaries run theirs. Equally obviously, the Endowment carried on its insurance operations "for the production of income." Both courts below found that the Endowment's insurance operations were unusually profitable and were consciously structured to be so, since it set its retail premiums far above its wholesale cost so as "to maximize dividends" and thus maximize profits (App., *infra*, 4a). In holding that the Endowment's insurance activities were not a "trade or business," the Federal Circuit simply ignored the language of the statute.

Given the language of the statute, the Federal Circuit's notion that the "phenomenal" and "astounding" profitability of the Endowment's insurance operations *negated* their trade-or-business status (App., *infra*, 8a) seems almost whimsical. The key criterion for assessing the existence of a "trade or business" under Section 513(c) is the presence of a profit-making motive. One would have thought that a motive, successfully executed, to make extraordinarily large profits would make an activity more of a "trade or business," not less of one.

This common-sense thought is consistent, not only with the statutory language, but with the economic facts. Economically speaking, the Endowment's insurance operations function as a business set up to exploit a very valuable, but virtually cost-free, asset—a pool of potential insureds, all ABA members, who have far-above-average mortality and morbidity experience. The Endowment could elect to exploit this asset in at least two ways, depending on its marketing strategy. It could charge below-market premiums, maintaining a modest level of profitability per insured but attracting a big market share. If it did that, many more lawyers would presumably join the ABA and buy insurance from the Endowment, since its premiums would be among the lowest available anywhere. If the Endowment chose to run its

insurance business in that way, it would make its profits (as do supermarkets) on volume, and would clearly—even under the decision below—have to pay unrelated business income tax on those profits.

Alternatively, the Endowment could elect, as it in fact did, to charge market-level premiums, maintaining a very high level of profitability per insured but settling for a more modest market share. On this approach, many lawyers might decide to buy insurance elsewhere, the Endowment's prices being roughly equivalent to those charged in the marketplace generally. But the Endowment would make lots of money on the lawyers who picked it. That is what the Endowment chose to do, and it should pay tax on its insurance income just as clearly as if it had chosen the high-volume, low-mark-up option discussed above.

Contrary to the conclusion of the courts below, finally, it is immaterial that the Endowment, in marketing its insurance, described its solicitations as "fundraising," or that the funds raised were channeled to the Endowment's educational projects (App., *infra*, 8a, 35a). Whenever a charity raises money, from an unrelated business or otherwise, its activity can be styled "fundraising," since the income is destined for—indeed, must, if the charity is to retain its tax exemption, be used exclusively for—charitable purposes. The profits NYU once derived from its macaroni factory (*C.F. Mueller Co. v. Commissioner, supra*) could equally have been labeled "fundraising," for the funds financed education. That is what prompted Congress to enact the unrelated business income tax in 1950, determining that tax-exempt groups should not be granted a tax subsidy at the expense of their taxpaying competitors in the marketplace, and enacting a statute that focuses on the *source*, not on the *destination*, of a tax-exempt organization's income. The rationale of the courts below—that the Endowment's insurance profits represented "charitable fund-raising"—simply begs the question, which is not whether the Endowment raised



funds for charitable purposes, but whether it raised funds for those purposes by running a "trade or business." As commentators on the Claims Court's decision have succinctly noted, "the court's emphasis on the destination of the profits for charitable purposes is wholly at variance with the genesis of the tax." Schwarz & Hutton, *Recent Developments in Tax-Exempt Organizations*, 18 U.S.F.L. Rev. 649, 684 (1984).

3. The question presented has considerable administrative importance. Group insurance plans are popular revenue-raisers for tax-exempt organizations. The IRS advises that in recent years it has issued dozens of private letter rulings responding to requests for guidance about the application of the unrelated business income tax to the insurance operations of tax-exempt groups. A preliminary IRS survey discloses 37 open or recently-closed audits involving this issue. Considering bar associations alone, a 1982 study by the Endowment (C.A. App. 1188) revealed that 90% of state bars offer group life, medical, and disability insurance, and that most large local bar associations sell various types of insurance as well.

The reasoning of the decision below could be pressed into service by hundreds of educational groups, fraternal societies, business leagues, and other tax-exempt membership associations nationwide. Under the court of appeals' theory, any group whose members are blessed with better-than-average health or longevity can offer group insurance at prevailing market rates without paying tax on its profits. As this case illustrates, these profits tend to be large, and the taxes at stake—for the Endowment, over \$6 million for the three years at issue—concomitantly substantial.

There is, moreover, no principled basis for confining the court of appeals' reasoning to insurance activities. Tax-exempt associations could operate vacation resorts, catalogue shopping centers, apartment houses, or any other profit-motivated enterprise for their members. So

long as they contrive to make extraordinarily large profits, and publicize to their members the charitable destination of those profits, they would seem under the Federal Circuit's reasoning to be as well situated as respondent to claim immunity from tax on their business receipts.

Aside from the revenue impact, the question presented is important because the unrelated business income tax has a significant regulatory function. Congress designed the tax, not just to raise money, but to keep the commercial endeavors of tax-exempt and non-exempt competitors on a par. The Endowment offers insurance at market prices and enjoys the patronage of some 57,000 ABA members. It competes directly with insurance brokers, plan administrators, and underwriters nationwide who vie for the business of those 57,000 lawyers. The fact that the Endowment elected to limit its market share by forbearing to underprice its competitors does not mean, as the Claims Court thought (App., *infra*, 48a), that its insurance business has "an entirely procompetitive effect." Quite the contrary: a tax-exempt group need not undersell everyone else in the market to run afoul of the policy of the unrelated business income tax. It must be rather cold comfort to respondent's competitors that respondent's insurance could be even cheaper than it is. Particularly is that so when the Endowment exploits its standing as a charitable organization to its commercial advantage by telling its members that their premiums are tax-deductible.

4. As noted earlier, the question presented here concerning the unrelated business income tax is connected to that on which the Court has granted certiorari in *United States v. American College of Physicians*, No. 84-1737 (July 1, 1985). The question in that case is whether a tax-exempt group's publication of commercial advertising, which it concedes to be a "trade or business," is "substantially related" to its educational purposes. The question here, by contrast, is whether a tax-exempt group's conduct of insurance operations, which it con-

cedes not to be "substantially related" to its educational purposes, is a "trade or business." The two questions, while obviously linked, involve the construction of different statutory phrases, appearing in different provisions of the Code, each illuminated by a unique legislative history, and each accompanied by a long and discrete tradition of judicial interpretation. This Court's decision in *United States v. American College of Physicians, supra*, therefore, is most unlikely to resolve the question of statutory construction presented here. For the reasons outlined above, that question merits this Court's plenary review.

**B. Frederic D. Turner, et ux., et al.**

1. Section 170 of the Code affords an income tax deduction for a "charitable contribution," defined as "a contribution or gift" to or for a charitable, educational, or other qualifying organization (I.R.C. § 170(c)(2)). The phrase "contribution or gift" is not further defined in the Code or Regulations. However, Congress made clear in the legislative history of the 1954 Code that a transfer of property constitutes a contribution or gift "only if there [is] no expectation of any *quid pro quo*." H.R. Rep. 1337, 83d Cong., 2d Sess. A44 (1954). For purposes of the charitable contribution deduction, in other words, "gifts" are limited to "those contributions which are made with no expectation of a financial return commensurate with the amount of the gift." S. Rep. 1622, 83d Cong., 2d Sess. 196 (1954).

Drawing upon this legislative history, the courts of appeals have consistently denied charitable contribution deductions to taxpayers who expect to receive, or do receive, an economic *quid pro quo* commensurate with the value of the property they transfer to charity. In *Sedam v. United States*, 518 F.2d 242 (1975), the Seventh Circuit denied a charitable deduction for a donation to an old-age home, where the "gift" was required as a condition of admitting patients. "It is at least clear," the court held, "that a payment is not a contribution or gift

under section 170 if it is made with the expectation of receiving a commensurate benefit in return" (518 F.2d at 245). In *Stubbs v. United States*, 428 F.2d 885 (1970), the Ninth Circuit upheld the denial of a charitable deduction for a developer's contribution of land to a municipality, where the transfer was made in the hope of obtaining favorable zoning treatment. The "gift" did not qualify for deduction under Section 170, the court held, because it "was in expectation of the receipt of certain specific direct economic benefits" (428 F.2d at 887). Indeed, the Federal Circuit's predecessor on previous occasions itself denied charitable deductions where "the transferor has received, or expects to receive, a *quid pro quo* sufficient to remove the transfer from the realm of deductibility under section 170." *Singer Co. v. United States*, 449 F.2d 413, 423 (Ct. Cl. 1971).

2. Consistently with these well-established principles, the Claims Court in the instant cases held that respondents were not entitled to deduct their insurance premiums as "charitable contributions" unless they could show that, in purchasing insurance from the Endowment, they had "bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise" (App., *infra*, 49a). Since respondents testified that they regarded the Endowment's insurance package as "reasonably or competitively priced" (C.A. App. 430), and since none of the respondents proved that he knew of a less-expensive insurance package available anywhere else, the Claims Court concluded that each had failed to show that he "purchased [the Endowment's] insurance for reasons other than his own economic interest" (App., *infra*, 54a). In short, because respondents failed to prove that the premiums they paid exceeded the fair market value of the insurance they bought, they were not entitled to charitable contribution deductions, having received, as they had expected to receive, "a financial return com-



mensurate with the amount of [their] gift[s]" (S. Rep. 1622, *supra*, at 196).

3. In reversing the judgment of the Claims Court, and in rejecting the legal standard it adopted, the Federal Circuit's decision is squarely at odds with fundamental tax principles enunciated by Congress and confirmed by other courts of appeals. The court below completely ignored the economic comparability between what respondents paid for and what they got. Instead, it adopted a vague and subjective standard mandating inquiry into "whether the relationship between the Endowment and the [respondents] was predominately of a business nature" (App., *infra*, 22a-23a). Under that standard, the Federal Circuit ruled, respondents on remand could "present a *prima facie* case for the deduction \* \* \* simply [by] mak[ing] a sworn assertion that they wanted to aid [the Endowment's] charitable endeavor and entered the Endowment's plan because it enabled them to do so" (*id.* at 22a). The burden of proof, the court said, would then shift to the government to "controvert that position and suggest factors showing that the transaction was basically business-oriented" (*ibid.*).

The court of appeals' reasoning is multiply flawed. It is contrary to the numerous cases holding that "a payment is not a contribution or gift under section 170 if it is made with the expectation of receiving a commensurate benefit in return" (*Sedam v. United States*, 518 F.2d at 245). Far from making out a *prima facie* case for a deduction, the self-serving affidavit contemplated by the court of appeals is entitled to no probative weight. Such an affidavit would sidestep the real question, which is not whether respondents bought insurance from the Endowment because they "wanted to aid [its] charitable endeavor" (App., *infra*, 22a), but whether they enrolled in its program with "no expectation of any *quid pro quo*" (H.R. Rep. 1337, *supra*, at A44). Tax cases, moreover, are no exception to the rule, acknowledged from time immemorial, that the plaintiff

bears the burden of proof. *Helvering v. Taylor*, 293 U.S. 507, 514-515 (1935); *Welch v. Helvering*, 290 U.S. 111, 115 (1933). Indeed, even "[a]fter satisfying the procedural burden of producing evidence to rebut the presumption in favor of the Commissioner, the taxpayer must still carry his ultimate burden of proof or persuasion." *Rockwell v. Commissioner*, 512 F.2d 882, 885 (9th Cir. 1975). The court of appeals' proposed affidavit procedure encroaches impermissibly on these long-settled rules.

Contrary to the court of appeals' belief, finally, the fact that respondents may be said to have "approv[ed] of and consent[ed] to" the Endowment's insurance program (App., *infra*, 8a) by agreeing to waive their entitlement to policy dividends makes no difference in determining whether they are entitled to charitable contribution deductions. Respondents, like all other ABA members, have absolutely no choice in this respect. If they will not waive their dividends, they cannot get insurance; it is simply part of the price of admission. The Endowment sets its price of admission fully cognizant of the valuable function it performs by assembling a pool of better-than-average insurance risks and negotiating favorable contracts with its underwriters. That in turn enables the Endowment to make big profits while keeping its retail price competitive. Many lawyers elect to pay that price because they cannot find a better deal elsewhere. The simple fact of the matter is that ABA members do not have access to the wholesale group insurance market, but must pay the retail price, and the Endowment in this respect charges whatever the retail market will bear. Respondents got what they paid for—insurance at market prices—and they accordingly have no claim to any charitable contributions.

4. Because the Federal Circuit remanded the individual respondents' cases with instructions to the Claims Court, the court of appeals' decision on the "charitable contribution" question is interlocutory. That issue is nevertheless suitable for this Court's immediate review.

It presents a clear-cut question of law, resolution of which is essential to the proper conduct of proceedings (if any) on remand. It is closely linked to the unrelated business income tax question presented in *American Bar Endowment*, as to which the Federal Circuit's judgment is final. The two questions draw on a common nucleus of facts, and the legal analysis brought to bear on the one may well illuminate the proper approach to be taken to the other. Indeed, in light of the Federal Circuit's description of the Endowment's insurance operations as "a fund-raising program" (App., *infra*, 2a), the two questions, in a sense, are reverse sides of the same coin, requiring analysis of the insurance transaction from the seller's and the buyer's viewpoint respectively. The charitable contribution question has considerable importance, potentially involving \$1.5 million in annual revenue and tax deductions of some 57,000 taxpayers in these cases alone. The court of appeals has stayed proceedings on remand pending disposition of this petition, and considerations of judicial economy favor resolution of the charitable contribution question now.

#### CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FRIED

*Acting Solicitor General*

ROGER M. OLSEN

*Acting Assistant Attorney General*

ALBERT G. LAUBER, JR.

*Assistant to the Solicitor General*

ROBERT A. BERNSTEIN

ROBERT S. POMERANCE

*Attorneys*

OCTOBER 1985

#### APPENDIX A

#### UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

---

Appeal No. 84-988

AMERICAN BAR ENDOWMENT, APPELLEE

*v.*

THE UNITED STATES, APPELLANT

---

Appeal No. 84-1000

FREDERIC D. TURNER, ET UX.,  
ARTHUR SHERWOOD, ET UX., ET AL., APPELLANTS

*v.*

THE UNITED STATES, APPELLEE

---

Decided: May 10, 1985

---

(1a)



Before FRIEDMAN, DAVIS, and BENNETT, *Circuit Judges*.

DAVIS, *Circuit Judge*.

These are consolidated appeals from the decision of the United States Claims Court, Kozinski, *C.J.*, in *American Bar Endowment v. United States*, 4 Cl. Ct. 404 (1984). In No. 84-988, the Government appeals from that portion of the ruling which held that appellee American Bar Endowment (the Endowment) earns no unrelated business taxable income from a fund-raising program in which the Endowment obtains a group insurance policy for its members and keeps (by assignment) the refunded dividends which accrue. In No. 84-1000, participating members of the Endowment (the individual taxpayers) appeal from the Claims Court's decision that they may not deduct the premium dividends (which they assign to the Endowment) as charitable contributions. In No. 84-988, we affirm; in No. 84-1000, we reverse and remand for further proceedings in accordance with this opinion.

# I.

## *Background*

The American Bar Endowment is a charitable organization the purpose of which is to support educational projects and research in the legal field. The Endowment is the principal source of funds for the American Bar Foundation, a research organization under the aegis of the American Bar Association (ABA). Although all members of the ABA are automatically members of the Endowment, the two organizations are separate legal entities. Because the Endowment is devoted to furthering educational projects, the Internal Revenue Service (IRS) has

determined that it is exempt from taxation under 26 U.S.C. § 501(c)(3) (1982).<sup>1</sup>

In the early 1950's the Endowment established the insurance plan which is the crux of these cases. In the now-pertinent particulars the plan is similar to any insurance program in which a central organization holds a group policy for which the organization's members pay a portion of the premium reflecting the amount of coverage they desire. In order to participate in the Endowment's plan, however, a member must assign to the Endowment all dividends to which he or she might be entitled. These dividends represent the difference between the premiums paid by the participants and the actual cost of coverage to the insurance company in terms of claims settlement, administrative expenses, and profits. *Cf. Penn Mutual Life Ins. Co. v. Lederer*, 252 U.S. 523, 525 (1920) ("It is the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policyholder.") Members who refuse to assign their right to the dividends are, according to the terms of the plan, not entitled to participate. The terms of the assignment are plainly set forth above the signature line in the contract between the participant and the Endowment.

During the period at issue here (tax years 1979-1981), the Endowment purchased policies from two insurance companies: New York Life Insurance Co. (a life insurance policy) and Mutual of Omaha Insurance Co. (other policies, *e.g.*, major medical and disability income insurance). The Endowment purchased the policies through a broker, James Group

<sup>1</sup> All further statutory citations are to this edition of title 26, the Internal Revenue Code of 1954, as amended.

Service, Inc. The insurance companies paid the broker a small percentage of the premiums as a commission.

The Endowment took sole responsibility for arranging the terms of the insurance, including the premiums and terms of coverage. Because the Endowment sought to maximize dividends, it had an incentive to set the premiums as high as possible without discouraging participation. The Endowment therefore set the premium at a level competitive with other insurance on the market; what the Endowment hoped is that it would benefit from the high dividends it could recoup as a result of the generally favorable morbidity and mortality experience of the attorney participants. This strategy has been extraordinarily successful. In the twenty-eight years from its inception to the time of this suit, the plan has grown from 12,000 to 55,000 participants. During this period the Endowment has recouped \$81.9 million in dividends, of which it has distributed \$63 million for educational projects. Currently, the Endowment employs approximately 40 people to administer the insurance plan.

Each year in which the Endowment receives a dividend on a group policy, which is more often than not, the Endowment notifies the participants as to the percentage of the total premium paid on that policy which it subsequently recouped as a dividend. These percentages are often as high as 30-40 percent, and sometimes 50 percent or over. Along with the notice, the Endowment advises participants that, in its opinion, that portion of the individual participant's payment which the Endowment received as part of the dividend is a tax deductible charitable contribution for the participant. As the prospect of litigation arose, the Endowment has included in the annual

notice a caveat to the effect that the IRS does not necessarily share its views.

These cases present two issues for our resolution. First, do the dividends which the Endowment receives from the insurance companies fall within the provisions concerning the taxation of the unrelated business income of otherwise tax-exempt organizations (such as the Endowment)? Second, are the participants in the Endowment's insurance plans entitled to deduct from their gross income that portion of their insurance payments which the Endowment recoups in dividends? We deal with these questions in the context of the separate appeals to which they pertain.

## II.

### *The Government's Appeal—Taxability of the Endowment*

#### A.

Congress has placed several provisions in the tax laws which grant beneficial treatment to charitable contributions. Of central importance are the tax forgiveness provisions in sections 170 and 501. Section 170(a), with exceptions and limitations not relevant here, authorizes taxpayers to deduct the value of charitable contributions from their gross income, thus allowing charitable donors to avoid taxation on that amount. Section 501(a) correspondingly exempts charitable organizations from taxation on the donations they receive. Under this arrangement, donations to charity are never taxed, either in the donor's hands or in the charity's pocket.

In the Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 947, Congress modified this scheme to insure that a charitable organization does not engage in a



commercial enterprise and thus take unfair advantage of its tax-exempt status to the detriment of competing businesses subject to taxation. The statute created an unrelated business income tax (unrelated business tax) on the income that a charitable organization receives from a trade or business unrelated to its charitable purpose.<sup>2</sup> See sections 511(a)(1), 512(a)(1). The term "unrelated trade or business" (for the purposes of this tax) means

any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of such organization of its . . . purpose or function constituting the basis for its exemption under section 501.

Section 513(a). In the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 941, Congress clarified the meaning of "trade or business": "For the purposes of this section, the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services." Section 513(c).

The regulations interpreting section 513 set forth a three-part test for determining whether a charitable organization's activity generates income subject to the unrelated business tax:

<sup>2</sup> See S. Rep. No. 2375, 81st Cong., 2d Sess. (1950), *reprinted in* 1950 U.S. Code Cong. Serv. 3053, 3081 ("The problem at which the tax on unrelated business income is directed is primarily that of unfair competition."); Treas. Reg. § 1.513-1(b), 26 C.F.R. § 1.513-1(b) (purpose of unrelated business tax is to put "the unrelated business activities of certain tax exempt organizations on the same tax basis as the nonexempt business endeavors with which they compete").

[G]ross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Treas. Reg. § 1.513-1(a), 26 C.F.R. § 1.513-1(a) (1984). By stipulation of the parties, only part (1) of this test—whether the Endowment carries on a trade or business by conducting the insurance plan—is at issue in the case regarding the Endowment's tax liability.

#### B.

In a technical advice memorandum dated July 3, 1980, the IRS informed the Endowment that, in the IRS' opinion, the insurance plan is an "unrelated trade or business" within the meaning of the statutory provisions imposing the unrelated business tax, and that the dividends constitute taxable income. The IRS reasoned that the Endowment sells its services as a group policyholder, without which its members could not enjoy the benefits of the plan's group rates. See G.C.M. 38940 (April 15, 1982), *reprinted in* [1982-1983 Transfer Binder] IRS Positions Rep. ¶ 1127 (for a full exposition of the IRS' reasoning). Based on this conclusion, the IRS conducted an audit and assessed a deficiency against the Endowment for the tax years 1979 and 1980, plus interest on the 1980 payment.<sup>3</sup> This was paid. The Endowment also

<sup>3</sup> The record is unclear as to why the IRS assessed no interest on the 1979 deficiency.



paid taxes on the dividends it received in 1981. On July 15, 1982 the Endowment filed a claim with the IRS for a refund of these payments. The IRS disallowed the claim on August 6, 1982. This refund suit followed and trial was held, resulting in factual findings and legal rulings.

In its opinion, the Claims Court undertook the rigorous task of parsing the relevant statutory provisions. As to the Endowment, the court deemed the appropriate query to be whether the Endowment "is 'operated in a competitive, commercial manner'." 4 Cl. Ct. at 409 (quoting *Disabled American Veterans v. United States*, 650 F.2d 1178, 1187, 227 Ct. Cl. 474 (1981) (*per curiam*)). If the insurance plan was found to be similar to a commercial, profit-making enterprise, the plan would fit within the definition of "trade or business" set forth in section 513(c) and the dividends would be income subject to taxation under the unrelated business provisions. Otherwise, they would merely be accumulated charitable funds and not subject to taxation.

The court concluded that the relevant facts and factors—which have been found here—including the Endowment's phenomenal success (particularly the astounding proportion of its gross premiums recouped as dividends); the persistent and fundamental fund-raising motivation of the program; and the knowledgeable approval of and consent to the program by the ABA's members—compelled the conclusion that the Endowment does not operate in a competitive, commercial manner. 4 Cl. Ct. at 410-11. Moreover, noting that section 513(c) of the unrelated business provisions requires taxation only of that income derived "from the sale of goods or the performance of services", the court determined that the

Endowment's receipts have far exceeded the value of any services which it might have performed in the course of its administration of the plan, and thus did not fit within the statutory definition of income from a trade or business. *Id.* at 411. Finally, the court noted that Congress' primary purpose in enacting the unrelated business income tax was to compensate for the unfair advantage that tax-exempt organizations have when they compete in the marketplace with commercial enterprises. Because (1) the Endowment employs commercial underwriters and brokers rather than performing these functions itself, and (2) the Endowment seeks to raise the price of its insurance rather than undersell other plans, the Claims Court held that the Endowment does not effectively compete with commercial, taxable insurance businesses, and therefore does not represent the sort of enterprise at which the unrelated business income tax provisions are directed. *Id.* at 413-14.

### C.

In No. 84-988, we affirm on the basis of Chief Judge Kozinski's opinion that portion of the decision below which held that administration of the insurance plan does not constitute an unrelated trade or business to which the unrelated business tax applies. The court applied the correct standard for determining whether the plan is a "trade or business" under section 513(c), properly found facts, and identified appropriate and convincing reasons for concluding that the Endowment did not meet the "competitive" and "commercial" criteria of *Disabled American Veterans*. We add only a few words in response to some of the Government's arguments on this appeal.

The Government considers this case to be identical to cases from other courts involving the application of the unrelated business provisions to group insurance plans. The three decisions which the Government cites are *Professional Insurance Agents of Michigan v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984); *Carolinas Farm & Power Equipment Dealers v. United States*, 699 F.2d 167 (4th Cir. 1983); and *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982). Chief Judge Kozinski found these cases to be inapposite, primarily because they involved insurance plans run by business leagues rather than charitable organizations. He reasoned that, because donations by members to the organization are business deductions and not charitable contributions, the receipts from their insurance plans could not be charitable contributions but must be income. We note an additional ground for distinguishing these cases: the business leagues received a stipend from the insurance companies for services provided to these companies, and not merely experience dividends which their members allowed them to keep. Their profits therefore fell within the definition of "trade or business" ("income from the . . . performance of services") contained in section 513(c). Furthermore, the business leagues, in performing these services, directly competed with commercial enterprises—such as James Group Service, the Endowment's broker—a situation in which Congress said the unrelated business tax should be imposed. S. Rep. 2375, *supra*; see also Treas. Reg. § 1.513-1(b), *supra*; *Disabled American Veterans*, 650 F.2d at 1181 & n.4.

The Government also argues that the very factors evaluated by the Claims Court establish that the Endowment operated in a competitive, commercial man-

ner. We are directed particularly to the fact that the Endowment set its rates "with reference to the rates for other insurance available in the market" and thereby maximized its receipts, *i.e.*, the Endowment set out to make as much "profit" as possible. 4 Cl. Ct. at 406. The Government concludes that this objective is characteristic of a commercial enterprise and results in direct competition with other group insurance services. Unlike what some other courts may do, this court does not find "profits," or the maximization of revenue, to be the controlling basis for a determination of whether the unrelated business tax provisions apply.<sup>4</sup> We consider not only the amount of money the charitable organization receives, but the source and character of these funds. In this connection the Claims Court specifically and permissibly rejected the Government's contention that the dividends represent a payment for the Endowment's services.<sup>5</sup> Because the Endowment's accumulation of funds was not the result of a commercial exchange, we agree with the Claims Court's view that the dividends do not constitute "profits" which fall within the defini-

---

<sup>4</sup> Compare, *e.g.*, *Louisiana Credit Union League*, 693 F.2d at 532 (intent to earn a profit determinative), with *Iowa State Univ. v. United States*, 500 F.2d 508, 517-18, (1974) (profits are evidence of a commercial purpose, but not conclusive).

<sup>5</sup> Compare *Disabled American Veterans*, 650 F.2d at 1187-88 (\$5 contribution viewed as payment in exchange for trinket of substantial value); *Steamship Trade Assn. of Balto. v. Commissioner*, 81 T.C. 303, 312 (1983) ("Petitioner [a business league which administers its members' employee vacation and annual income funds] clearly sells a service for which it receives a substantial sum of money"), *aff'd*, No. 84-1099 (4th Cir. March 27, 1985).



tion of section 513(c).<sup>6</sup> A charity should not be subject to taxation merely because its charitable solicitations are successful. This would, however, be the result if we adopted the IRS' reasoning in this case.

### III.

#### *The Taxpayer's Appeal—Deductible Charitable Contributions*

##### A.

The taxpayers' appeal concerns the effect of section 170 on the agreement to assign dividends to the En-

---

<sup>6</sup> On the conclusion reached below, which we accept, our refusal to view the recouped dividends as payment for the Endowment's services is consistent with the IRS' own memoranda. In G.C.M. 38940 (April 15, 1982), *reprinted in* [1982-1983 Transfer Binder] IRS Positions Rep. (CCH) ¶ 1127 at 3444, the IRS stated that a group policy holder such as the Endowment "serves as group policyholder *in exchange for which* the individual insured members agree to pay premiums and irrevocably assign their share of the premium refunds." (Emphasis in original.) In G.C.M. 38955 (June 29, 1982), *reprinted in* [1982-1983 Transfer Binder] IRS Positions Rep. (CCH) ¶ 1157, the IRS stated that a similar plan did not subject a charitable organization to taxation if it offered to distribute the dividends to those participants who so requested. The IRS concluded that the offer of a rebate negated the presumption that the dividend was consideration for the organization's services. In the present case, the Claims Court specifically found that the assignment of dividends was not an exchange for services, but rather reflected the intention of the membership to support the Endowment's charitable activities. This case therefore falls within the rule of G.C.M. 38955, rather than G.C.M. 38940. In any event, we fail to see how one plan competes any less with commercial group insurance plans than the other. If any difference exists, the plan which offers to distribute the dividends presents the greater possibility of competition with taxed organizations.

dowment. Section 170(a) provides: "There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year." Section 170(c) provides only that a contribution is a "contribution or gift to or for the use of" certain types of organizations, of which the Endowment is one. The only real clue as to what Congress intended by the term charitable contribution is a comment regarding section 162(b),<sup>7</sup> in which Congress said that charitable contributions are donations "made with no expectation of a financial return commensurate with the amount of the gift." H. Rep. No. 1337, 83d Cong., 2d Sess. (1954)), *reprinted in* 1954 U.S. Code Cong. & Ad. News 4018, 4180; S. Rep. No. 1662, 83d Cong., 2d Sess. (1954), *reprinted in id.* at 4621, 4831. The issue on the taxpayers' appeal is whether the required payments of the dividends to the Endowment were deductible contributions.

##### B.

By a letter of August 7, 1980, the Endowment informed its members that, under a ruling which the Endowment had requested, the IRS, beginning in tax year 1980, would not allow participants to deduct under Section 170 the dividend portion of their insurance premiums recouped by the Endowment as charitable contributions. The individual taxpayers in this case, all of whom failed to deduct the portion of his dividend recouped by the Endowment in 1981, filed a claim for a refund. In each case, six months passed without a response from the IRS. They then filed a

---

<sup>7</sup> Section 162(b) provides that contributions which exceed the limitations of section 170 are not deductible as trade or business expenses.



timely complaint in the Claims Court which was consolidated with the Endowment's case. A trial was also held on the individual taxpayer's case.

The Claims Court recognized that a given transaction can possess dual characteristics, being at the same time a commercial transaction and a charitable contribution. The relevant question (according to the court) is the size of each of these components. Under the rule thought to guide such an inquiry, "the taxpayer must demonstrate that he bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise." *Id.* at 415 (citing Rev. Rul. 67-246, 1967-2 C.B. 104, 105). If the taxpayer receives from the charity some recompense entirely commensurate with the value of the payment, then no dual payment situation arises because the charitable contribution portion of the payment is zero. In addition, under the Claims Court's formulation, the taxpayer must prove that the payment was accompanied by a specific intention to make a charitable contribution.

In an effort to determine the value of the compensation received by the participants in the Endowment's insurance plan, the Claims Court looked to the value of similar insurance plans available to each taxpayer. That was the critical test. In the Claims Court's eyes, three of the taxpayers failed to prove that they were eligible to participate in a cheaper insurance plan; they thus failed to establish the charitable contribution component of their payments. One taxpayer demonstrated that he was eligible for cheaper insurance, but he failed to state that he knew of that insurance during the years in issue; the court found that he therefore failed to establish the requisite intent to make a charitable contribution. All the individual claims were thus disallowed.

### C.

The taxpayers' case is unusual. Neither side has cited, nor have we found in our research, any case in which the issue was the deductibility under section 170 of an assignment of insurance dividends to a charitable organization which held the group insurance policy. On appeal, the Government argues that the Claims Court's decision correctly placed the burden of proving a charitable motive—which the Government argues is the *sine qua non* of a deduction under section 170—on the taxpayers. The Government also defends the court's particular method of determining charitable motive. We hold, however, that well established principles of tax law from this circuit and elsewhere require that we reject the unitary approach of the court below and remand for consideration in accordance with those principles as they should be applied to this unique situation.

As noted *supra*, the tax code does not expressly define the term "charitable contribution." We can make some headway, however, by determining what a charitable contribution is not. First and foremost, a charitable contribution is not an exchange. In *Singer Co. v. United States*, 449 F.2d 413, 196 Ct. Cl. 90 (1971), the Court of Claims established that a donation is not deductible if the donor anticipates substantial economic benefit from the act. The court stated:

It is our opinion that if the benefits received, [sic] or expected to be received, are substantial, and meaning by that, benefits greater than those that inure to the general public from transfers for charitable purposes (which benefits are merely *incidental* to the transfer), then in such case we feel the transferor has received, or expects to receive, a *quid pro quo* sufficient to re-

move the transfer from the realm of deductibility under section 170.

*Id.* at 423 (emphasis in original); accord, *Ottawa Silica Co. v. United States*, 699 F.2d 1124, 1132 (Fed. Cir. 1983) (*per curiam*) ("The plain language [of *Singer*] clearly indicates that a 'substantial benefit' received in return for a contribution constitutes a *quid pro quo*, which precludes a deduction.")

In *Singer*, the taxpayer sold sewing machines to schools at bargain prices with the (unrealized) expectation that those trained on Singer machines would later purchase Singer products. In *Ottawa Silica*, the taxpayer donated a parcel of land to a school district in anticipation of increasing the value of its surrounding holdings, which the taxpayer planned to divide into residential lots. In each case the court ruled that the expectation of future benefits removed the donation from the term "charitable contribution" as used in section 170.

On the other hand, the courts and the IRS have recognized that, as a practical matter, one can transact business with a charitable organization in such a way that the *quid pro quo*, though more than "incidental to the transfer" under the *Singer* test, is never expected by either party to the transaction to have a substantial bearing on the amount of the gift. An oft repeated situation is the purchase of tickets to charitable functions (*e.g.*, dinners), the return for which (the meal and any entertainment) is nowhere near the worth of the price of admission. The IRS has taken the position on many occasions that the donor is entitled to a deduction for the difference between the amount of the donation and the fair market value of whatever is received (or at least expected) in re-

turn. Rev. Rul. 67-246, 1967-2 C.B. 104 (price of tickets to charity ball deductible to the extent it exceeds the fair market value of attending the function); Rev. Rul. 76-185, 1976-1 C.B. 60 (agreement by which taxpayer agreed to refurbish an old house in exchange for use of the house for a term of years resulted in a deductible contribution to the extent that the renovation expenses exceeded the fair rental value of the property for the term of the lease). In Rev. Rul. 68-432, 1968-2 C.B. 104, 105, the IRS stated:

Whenever the discrepancy between the size of the membership contribution and the potential monetary benefits is so great as to make it reasonably clear that the payment is of a dual character, the [IRS] will give due consideration to the possible separation on a uniform basis of that portion of the total payment that may properly be treated as a charitable contribution under section 170 of the Code.

The courts have also adopted this rule. *Marshall v. Welch*, 197 F. Supp. 874 (S.D. Ohio 1961) (donation to nursing home deductible in amount in excess of the cost of a wheelchair for donor's son purchased by the home); *Arceneaux v. Commissioner*, 36 T.C.M. (CCH) 1461, 1464 (1977) ("[T]o prevail, petitioners must show that the amount paid in 1972 to the [charity] exceeded the value of the services rendered by the adoption agency and that such excess was intended as a gift") (emphasis in original); *DeJong v. Commissioner*, 36 T.C. 896, 900 (1961), *aff'd*, 309 F.2d 373 (9th Cir. 1962) (deduction of contribution to school disallowed to the extent of the market value of education of taxpayer's children).



In Rev. Rul. 67-246, *supra*, the IRS set forth two conditions for proving a charitable component to a transaction in this context. First “an essential element is proof that the portion of the payment claimed as a gift represents the excess of the total amount paid over the value of the consideration paid therefor.” 1967-2 C.B. at 105. The IRS recognized, however, that under this formulation a person who enters into a bad bargain with a charity (*i.e.*, the purchase price exceeds the fair market value of the property or services received) might attempt to deduct the difference as a charitable contribution. The IRS therefore ruled that evidence pertaining to the nature of the exchange is also critical:

Another element which is important in establishing that a gift was made in such circumstances, is evidence that the payment in excess of the value received was made with the intention of making a gift. While proof of such intention may not be an essential requirement under all circumstances and may sometimes be inferred from surrounding circumstances, the intention to make a gift is, nevertheless, highly relevant in overcoming doubt in those cases in which there is a question whether an amount was in fact paid as a purchase price or as a gift.

*Id.* The Court of Claims imposed a similar standard in *Singer*; the court denied the deduction as to the sales to schools because *Singer* expected an important business *quid pro quo*, and the sales were thus “of a business nature and not charitable.” 449 F.2d at 424. *Accord, Ottawa Silica*, 699 F.2d at 1132 (the nature of the arrangement in that case “effectively destroyed the charitable nature of the transfer.”)

In *Rusoff v. Commissioner*, 65 T.C. 459 (1975), *aff'd*, 1977-1 USTC ¶ 9338 (2d Cir. 1977), the Tax Court considered the question whether an arrangement by which a group of inventors assigned to Columbia University one-half of their interest in a patent for a cigarette filter resulted in a deductible contribution by the inventors. Columbia agreed to investigate the development of the filter and defend the patent. The court looked to the circumstances surrounding the assignment, including “events surrounding the transfer and the legal documents executed by the parties,” in an effort to “expose the true nature of the transaction.” *Id.* at 469. The Tax Court concluded that “the evidence in its entirety . . . clearly shows that the transfer to Columbia was a business transaction, not a charitable contribution.” *Id.*

#### D.

As we have pointed out, the Claims Court in the instant case concluded that these standards require a definite comparison between the cost of the Endowment’s insurance plan and the cost of other plans available to the particular taxpayers—and also that the taxpayer has the burden of showing that the Endowment’s plan is more expensive. The theory underlying this position is that, if the Endowment’s insurance is the cheapest available, then the taxpayers’ participation is “economically motivated, that is, where the payment is made to obtain goods or services for which the taxpayer would be willing to pay the full price even absent the charitable contribution.” 4 Cl. Ct. at 415. Our difficulty with this comparison, as the precise litmus test of charitable vs. non-charitable transactions, is that it is an incorrect definitization of the proper standard.



First, the Claims Court's test requires that the taxpayers prove more than a charitable transaction, as *Singer* requires, but actually affirmatively prove a charitable motivation of disinterested generosity.<sup>8</sup> In *Singer*, however, the Court of Claims expressly rejected a pure motivational requirement, noting, *inter alia*, that this requirement places too harsh a burden on taxpayers. 449 F.2d at 421-22.

Second, the Claims Court's comparison can support the opposite conclusion from the one it draws. By comparing the cost of different plans, the court below failed to take into account the fact that, in other plans, the participants are entitled to their dividends. This lowers the net cost to them of the insurance. To the extent that it is relevant, this comparison can be said to indicate that the participants voluntarily forwent a right to which they would otherwise be entitled as a consequence of their participation in the plan.

Third, the Claims Court's overly-precise formulaic test assumes that all participants are purely "economic" persons, acting solely on a careful and detailed comparative investigation of pecuniary results and expectations. That is by no means a universal assumption and there are many who may be able to show that they made a charitable donation of the dividends to the Endowment, without proving that they deliberately and intentionally chose, after careful inquiry, the Endowment plan over other "bet-

<sup>8</sup> In particular, the Claims Court required that, to be deductible, the insurance plan must be a bad deal for the taxpayer, and the taxpayer must know that he could do better elsewhere. 5 Cl. Ct. at 417-18. This indicates a predominant motivational requirement of disinterested generosity, to be proved by the taxpayer.

ter deals." In life, an intention to enter into a charitable transaction is often intertwined with other motivations, including some that are non-charitable.

Rather, the general question to be posed according to *Singer* and *Ottawa Silica* is whether the transaction between the Endowment and the taxpayers involving the assignment of dividends "was of a business nature and not charitable." 449 F.2d at 424. This determination must flow from an examination of all the pertinent circumstances surrounding the individual transaction—there is no single-factor test.<sup>9</sup> For instance, the record in this case shows that several participants in the Endowment's plan sought to evade or negotiate away the requirement that they assign the dividends. Some even sought to negotiate with the Endowment to remove the assignment clause from the contract.<sup>10</sup> A trial court might reasonably conclude that these individuals expected that the Endowment would provide the best possible insurance opportunity despite the assignment requirement; that this expectation colored the transaction and out-

<sup>9</sup> Taxpayers seem to say that the only test is whether the value of the services rendered by the charity is greater than or equal to the claimed charitable donation—and that in the present case it is clear that Endowment's services were worth much less than the assigned dividends. Like the Claims Court's single-factor formula, taxpayers' position has the advantage of simplicity but it flies in the face of the multifaceted inquiry mandated by *Singer-Ottawa Silica* which looks at the entire transaction, including of course the factor of relative values, but also that of overall purpose, donative intent, etc.

<sup>10</sup> The tenor of a negotiation, indeed the fact of a negotiation itself, may indicate that the resulting agreement is of a business and not a charitable character. *Rusoff*, 65 T.C. at 471.

weighed other factors; that the transaction was therefore of a business and not a charitable nature; and that the taxpayer should be denied a deduction. On the other hand, many participants may have entered the Endowment's plan because of the notion that they could accommodate their insurance needs and at the same time substantially support a worthy charitable goal (and, indeed, generate a tax deduction). As to these individuals, a trial court might draw the exact opposite conclusion, and decide that a deduction is proper.<sup>11</sup> It should not be too difficult for participants of this latter type to present a *prima facie* case for the deduction. In the light of the Endowment's persistent and public efforts to enhance its charitable funds, it would be enough, until properly challenged, for participants simply to make a sworn assertion that they wanted to aid that charitable endeavor and entered the Endowment's plan because it enabled them to do so. The Government could, of course, controvert that position and suggest factors showing that the transaction was basically business-oriented.

As for the particular taxpayers involved in this case, the record is almost completely bare as to the nature of their dealings with the Endowment outside of the fact that they did indeed participate in the Endowment's plan and knew about the requirement to assign the dividends. We therefore reverse and remand for such further proceedings as are appropriate to determine whether the relationship between

---

<sup>11</sup> For example, "The magnitude of the economic benefit conferred upon the charity is itself strongly probative of a donative intent." *Mason v. United States*, 513 F.2d 25, 27 n.9 (7th Cir. 1975) (*per Stevens, J.*).

the Endowment and the taxpayers was predominately of a business nature or whether the transaction did have a substantial charitable component.

For these reasons, No. 84-988 is affirmed and No. 84-1000 is reversed and remanded.

*AFFIRMED IN PART, REVERSED AND REMANDED IN PART.*

24a

APPENDIX B

UNITED STATES COURT OF APPEALS  
FOR THE FEDERAL CIRCUIT

---

No. 84-988

465-82T et al.

AMERICAN BAR ENDOWMENT, APPELLEE

v.

THE UNITED STATES, APPELLANT

---

No. 84-1000

465-82T et al.

FREDERIC D. TURNER, ET UX.,  
ARTHUR SHERWOOD, ET UX., ET AL., APPELLANTS

v.

THE UNITED STATES, APPELLEE

---

JUDGMENT

*On Appeal from the United States Claims Court*

*This Cause having been heard and considered, it is  
Ordered and Adjudged:* No. 84-988 is AFFIRMED  
and No. 84-1000 is reversed and remanded to the  
Claims Court consistent with the attached opinion.

DATED May 10, 1985

ENTERED BY  
ORDER OF THE COURT

/s/ George E. Hutchinson  
GEORGE E. HUTCHINSON  
Clerk

Issued as a Mandate: June 6, 1985

25a

APPENDIX C

IN THE UNITED STATES CLAIMS COURT

---

Nos. 465-82T, 163-83T,  
190-83T, 320-83T,  
351-83T

AMERICAN BAR ENDOWMENT,  
FREDERICK D. TURNER ET UX.,  
ARTHUR M. SHERWOOD ET UX.,  
FREDERICK G. BOYNTON and  
HERBERT C. BROADFOOT, II ET UX., PLAINTIFFS

v.

THE UNITED STATES, DEFENDANT

---

[Filed: Jan. 31, 1984]

---

OPINION

KOZINSKI, Chief Judge.

These consolidated cases present questions relating to the operation of group insurance plans by the American Bar Endowment (ABE), a tax-exempt charitable organization. In No. 465-82T, the question is whether operation of the plans is a trade or business and therefore subject to the Unrelated Business Income Tax (UBIT), 26 U.S.C. §§ 511-513 (1976 &



Supp. V 1981), or a fundraising activity and therefore not taxable. In Nos. 163-83T, 190-83T, 320-83T and 351-83T, the question is whether the individual plaintiffs are entitled to a charitable contribution deduction for dividends that were paid by the insurance companies under the ABE group plans and retained by ABE.

#### Facts<sup>1</sup>

##### A. HISTORICAL BACKGROUND

The American Bar Endowment is a charitable organization exempt from taxation under 26 U.S.C. § 501(c)(3) (1976). Its charitable purposes are to promote legal research and education in order to advance the administration of justice and the science of jurisprudence. The Endowment accomplishes its purposes by making grants and is the primary supporter of projects undertaken by the American Bar Foundation, the research arm of the American Bar Association. While all members of the ABA are automatically members of the Endowment, the Endowment is a separate legal entity.

The ABE was established in 1942, and ABA/ABE members were encouraged to contribute to it through gifts and bequests. By the early 1950's, however, it became clear that sporadic individual donations would not permit the Endowment to fulfill its objectives. To remedy this situation, a fundraising plan was proposed based upon the sale of group life insurance. Under this plan, the Endowment would make insurance available to its members at group rates. To

<sup>1</sup> The court made oral findings of fact on the record after trial. This opinion supplements those findings as appropriate to the resolution of the legal issues discussed.

participate in the plan, members would have to assign to the ABE any dividends or experience credits earned under the insurance policies.<sup>2</sup> The ABE group life insurance plan went into effect on June 1, 1955, with fewer than 12,000 subscribers.

From its modest beginnings, the ABE group insurance program has grown in size and importance. Over the years, the types of insurance and amount of coverage have increased, as have the insurance-related services performed by the Endowment staff. By the late 1970's and early 1980's, the period here in issue,<sup>3</sup> over 55,000 ABE members participated in the program, which was managed by a staff of about 40. Term life insurance of up to \$150,000 was available, as was coverage for accidental death/dismemberment, major medical, in-hospital indemnity and disability income. Some insurance was also available for dependents under most of these policies.

During the years in issue, ABE's insurance program was underwritten by two companies, New York Life Insurance Co. (life programs) and Mutual of Omaha Insurance Co. (other programs). The Endowment employed James Group Service, Inc., a broker licensed by the state of Illinois, in connection with the purchase of insurance. The broker earned as commission a small percentage of all premiums. The commission was paid by the insurance companies but was in fact negotiated by ABE.

<sup>2</sup> Dividends or experience credits are portions of a year's premium that are refunded by the insurance company in light of its claims experience and other expenses. The concept is discussed at greater length below. See p. 3 *infra*.

<sup>3</sup> The tax years in issue are 1979, 1980 and 1981. Because the Endowment's tax year begins on July 1, the period in question in No. 465-82T is July 1, 1978, to June 30, 1981.

## B. THE INSURANCE PROGRAM

### 1. *The Endowment's Strategy*

All of the insurance plans offered by ABE are of the participating type. Participating insurance offers the possibility that dividends or experience credits (hereinafter collectively "dividends") may be re-funded to the insured at the end of each year. Whether dividends are paid in a given year depends upon two factors: the size of the premium initially collected (the initial or gross premium) and the costs incurred by the insurance company during the preceding year (principally with respect to the payment of claims). The larger the initial premium, the larger the expected dividend; similarly, the more favorable the claims experience, the larger the dividend.

Over the years, the Endowment sought to maximize the dividends received under the various insurance plans. It pursued this strategy by encouraging the insurance companies to set initial premiums as high as possible and by attempting to secure the lowest cost structure in the computation of dividends.

a. *Maximizing Premiums.* Setting the gross premium charged ABE members was technically the prerogative of the insurance companies. However, the companies always consulted with the Endowment, whose leadership had a significant role in determining premium rates. In general, the Endowment's leadership favored large initial premiums which could be expected to generate large dividends. The insurance companies generally favored lower gross premiums in order to attract the most participants.

While the Endowment sought to set gross premiums high, it did not do so blindly. The Endowment was aware that the level of premiums charged could

affect participation in the insurance programs. It therefore set premiums so as to maximize the total volume of dividends collected. This meant that gross premiums were set with reference to the rates for other insurance products available in the market.<sup>4</sup> In pursuit of this policy, Endowment staff reviewed other insurance products available to ABE members and compared them to those offered by the Endowment. Where appropriate, adjustments were made to keep the cost of ABE insurance more or less competitive. However, premiums were never set so as to make ABE insurance the best deal. Because of the low costs associated with ABE insurance, premiums could have been set much, much lower if maximizing participation had been the principal objective. It was the Endowment's policy, however, to operate only those insurance plans capable of generating substantial dividends in the long run.

b. *Minimizing Costs.* In addition to keeping premiums high, the Endowment did much to keep the costs attributable to Endowment insurance plans low. The most significant factor in lowering costs was to cause

---

<sup>4</sup> Premiums, particularly for life insurance, were generally most competitive at younger ages and least competitive at older ages. This reflected two considerations. First, there was significant concern with bringing younger members into the insurance program. Once in the program, members would be likely to continue participation (even when premium rates became less competitive) because of inertia or because they might be precluded from obtaining other insurance. Second, the ability and willingness to make charitable contributions was expected to increase with a member's age and concomitant rise in income. Older members were therefore more likely to stay in the program even though an increasing portion of their dividends was devoted to charity rather than the purchase of insurance.



the insurance companies to compute net premiums on the basis of the most favorable risk ratings. Because the method for determining such ratings is important to various aspects of the case, it warrants discussion.

Insurance premiums for individual (nongroup) insurance are based on a person's life expectancy (mortality) for life insurance and expectancy of illness (morbidity) for health and disability insurance. These expectancies are derived from statistical tables that provide accurate information for the entire population but can only serve as approximations for any one individual. Characteristics such as present health, tobacco use or occupation have a significant bearing on the likelihood that a person will die or become disabled. Insurance companies therefore attempt to discover these factors in order to make an appropriate premium adjustment or to deny coverage altogether.

Screening these risk factors can be time consuming and costly, and may require detailed questionnaires and medical examinations. The more exacting the process, the more likely that the premium charged will reflect the risk incurred. However, as the screening process becomes more difficult, it also becomes more expensive for the company and more discouraging to applicants. Insurance companies therefore try to identify applicants with better than average life or health expectancy through methods that minimize or eliminate individual screening.

One such method is to identify groups whose members have more favorable mortality or morbidity statistics than the general population. Professional associations are prime examples of such groups. Members of professional associations are generally better educated than the population as a whole and more likely to be well nourished and have access to

first-rate medical care. Professional associations also generally consist of members of a single profession, excluding individuals with more hazardous occupations.

While mortality and morbidity tables geared to a particular profession provide a better approximation of risks than tables geared to the population at large, the experience of a particular group within a profession may differ from the experience of the profession as a whole. Under certain circumstances, it is possible for an insurance company to arrive at a still more precise measurement of risks by providing insurance based on the experience of the group itself. This can only be done with a group that is large enough to provide a statistically meaningful experience that is not likely to fluctuate greatly from year to year. When an insurance company sets rates for a group on the basis of that group's own experience, that insurance plan is deemed to be experience rated. By further lowering costs, experience rating provides significant advantages in calculating dividends for participating insurance plans.

An important cost advantage secured by the Endowment was to assure that the ABE insurance plans were experience rated. Because the mortality and morbidity experience for the group was more favorable than for the legal profession as a whole, the net cost of ABE insurance was lower than the net cost of insurance available through other bar associations. The Endowment was also able to secure additional advantages. For example, while it collected premiums from members semi-annually, it transmitted them to the insurance companies only once a year, gaining the benefit of the float on a portion of the premiums. As to one of the plans, it was able to avoid charges for a

certain type of reserve by establishing an escrow account with its own securities to absorb the risk. In general, the Endowment leadership used the size and prestige of the ABE account to vigorously negotiate the most advantageous possible cost structure for each of the insurance plans.

This strategy of cutting costs and keeping gross premiums high has been fabulously successful. Over the 28 years that the insurance program has been in effect, the Endowment has netted an astounding \$81.9 million in dividends, \$63 million of which it has devoted to its charitable endeavors. It should be noted that not all Endowment insurance programs have been equally successful in raising revenues in every year. However, on an overall basis, the Endowment's strategy was successful and it is clear that any plan not expected to generate large dividends in the long run would have been discontinued regardless of its popularity.

## 2. *Individual participation*

Individual ABE members were well informed about the fundraising nature of the insurance program. Advertising and promotional materials clearly indicated that objective. As a condition for participating in any of the plans, members agreed to assign all premium refunds to the Endowment. Applications for insurance contained such an assignment immediately above the signature line.

Dividends were calculated by the insurance companies separately for each of the Endowment's five insurance plans. At the end of each year, the underwriter for each plan refunded to the Endowment that portion of the gross premiums exceeding the cost of servicing that plan. The Endowment kept the money

and informed members participating in each plan what percentage of the total premiums had been refunded and used for charitable purposes. Many members then multiplied the stated percentage by the amount they had paid in premiums under that plan and deducted that amount from their income taxes as a charitable contribution. Each of the individual plaintiffs did so with respect to one or more of the insurance plans in one or more of the years in issue.

## Discussion

The court must determine whether the Endowment's activities amounted to a trade or business subject to the UBIT and whether the individual members are entitled to deduct a portion of their premiums as charitable contributions. Although these questions have some elements in common, they present separate issues and require separate legal analyses.

### A. *THE ENDOWMENT*

1. The Unrelated Business Income Tax, as its name suggests, is levied on the "unrelated business income" of certain tax-exempt organizations. 26 U.S.C. § 511(a)(1) (1976). Unrelated business taxable income is defined as "the gross income derived by any organization from any unrelated trade or business." *Id.* § 512(a). "Trade or business" in turn is defined as "any activity which is carried on for the production of income from the sale of goods or the performance of services." *Id.* § 513(c) (emphasis added).

When considering a tax-exempt organization that is a charity, the court must distinguish between those activities that constitute a trade or business and those that are merely fundraising. Over the years, chari-



ties have adopted fundraising schemes that are increasingly complex and sophisticated, relying on many business techniques. See, e.g., Wingis, *Fund Raiser Profits From New Techniques*, Advertising Age, Jan. 17, 1983, at M-42; Shapiro, *Marketing for Nonprofit Organizations*, Harv. Bus. Rev., Sept.-Oct. 1973, at 123. Charitable activities are sometimes so similar to commercial transactions that it becomes very difficult to determine whether the organization is raising money "from the sale of goods or the performance of services" or whether the goods or services are provided merely as an incident to a fundraising activity.

Fortunately, the Court of Claims provided significant guidance on this issue in its well-reasoned opinion in *Disabled American Veterans v. United States*, 227 Ct. Cl. 474 (1981). That case involved a charitable organization that engaged in a variety of activities each of which provided revenues to the organization. The court held that some of the activities constituted a trade or business, and therefore produced income subject to the UBIT, while others were fundraising activities and not taxable. The test enunciated by the court in *Disabled American Veterans* is whether the activity in question is "operated in a competitive, commercial manner." *Id.* at 489. Operations not conducted in such a manner were deemed to be fundraising activities not subject to the UBIT.

Whether an activity is operated in a competitive, commercial manner is a question of fact and turns upon the circumstances of each case. At bottom, the inquiry is whether the actions of the participants conform with normal assumptions about how people behave in a commercial context. If they do not, it may be because the participants are engaged in a charitable fundraising activity. *Disabled American Vet-*

*erans* illustrates this point. Among the activities considered in that case was the sale of certain items such as books, maps, charts and wrist calendars. 227 Ct. Cl. at 482-83. The court found that some of those items were sold by the charitable organization at prices close to their market value. As to those items, the activity was held to be a trade or business because the motivation of the buyers could be explained entirely in terms of a commercial transaction. Certain other items were sold at prices far in excess of their market value. As to those items, the court found that the sales activity was not a trade or business because the actions of the buyers could not be explained by reference to commercial motivations but only by an intent to participate in a charitable fundraising activity.

2. In determining whether the ABE insurance program was operated in a commercial manner it is appropriate to start with the observation that the program was devised as a means for fundraising and has been so presented and perceived from its inception. When the program was first developed in the mid-1950's, professional association group insurance was virtually unheard of. The idea of offering coverage through voluntary group participation was a pioneering idea in the insurance industry, so much so that the Endowment had some difficulty finding an underwriter for the program. The availability of group insurance of various types has proliferated over the intervening three decades; in many instances group insurance plans have been operated and promoted for commercial purposes. It is significant, however, that the ABE did not develop its fundraising plan by copying or adapting commercial ventures but vice versa.

Despite the widespread commercialization of group insurance plans, the Endowment has stubbornly adhered to the original concept that its plans are exclusively for fundraising. Advertising and other promotional materials consistently referred to the use of dividends for the Endowment's charitable endeavors; the Endowment's annual reports discussed the insurance program as a source of charitable contributions; communications to policyholders consistently referred to the Endowment's retention of dividends as donations, not as profits. In short, both the ABE leadership and the insured members considered the insurance program a fundraising activity and treated it as such.<sup>5</sup>

It is, of course, inappropriate to give the perceptions and labels of the parties conclusive effect. However, it is also wrong to ignore these facts altogether. *Disabled American Veterans* requires a determination as to the motivation of the participants in the transaction. The manner in which the program was presented and perceived can be an important factor in that determination. This is particularly so where, as here, the transaction is relatively unusual, defying ready classification, and the perception of the program as a fundraising activity has been held by many thousands of people for the better part of three decades.

Another significant factor is the staggering amount of money consistently generated by the Endowment's

<sup>5</sup> Even those ABE members who testified for the defendant appeared to share this view. While these witnesses disagreed with the manner in which the program was operated and would have preferred to pay lower premiums by terminating the program's fundraising function, they certainly never suggested that the Endowment was operating a business which was profiting at their expense.

activities. In 1979, the Endowment collected \$12.8 million in gross premiums and received about \$5.1 million in dividends. Its expenses were less than \$1.5 million. If this were a business, as defendant suggests, its profit margin would have been 240%. For 1980 and 1981 profit margins would have been over 400% and 260%. These margins were typical; over the years the Endowment has netted approximately 300% over expenses.

The evidence presented and common sense suggest that such profit margins cannot be maintained year after year in a competitive market. With one exception, no business involved in the underwriting, sale, brokering or administration of insurance has been able to earn profits even approaching this level. The exception involved sales of insurance to a captive market, a practice considered abusive and promptly subjected to regulation in many states.<sup>6</sup> Certainly no legitimate business has been able to match the astounding profitability of ABE's program, and no business (legitimate or otherwise) has been able to maintain that level of profit for any sustained period.

Yet another significant factor is the Endowment's candor toward its members and the public concerning the operation of the insurance programs and the revenues derived therefrom. ABE went to great lengths to publicize all relevant facts in annual reports, direct communications with insured members, promotional materials and other ways. As is typical of charitable fundraising campaigns, the ABE took great pride in letting the world know how much

<sup>6</sup> An example of this practice were lenders who sold credit insurance to people applying for loans. The granting of the loan was conditioned on the purchase of insurance. This put significant pressure on the borrower, enabling the lender to charge exorbitant rates for the insurance.



money was collected each year and the uses to which the money was put. This openness creates yet another contrast with normal perceptions of a business. Generally, business enterprises strive to keep their profit margins secret, particularly where those margins are inordinately high.

The final and most telling factor is that the insurance program was operated with the approval and consent of the ABA membership. The ABA consists of some 300,000 members who have the good fortune of belonging to a group with a very favorable mortality and morbidity rating. This is a valuable asset. Most professional associations (including almost all bar associations) operate such programs on a service-oriented basis and secure the most economical group insurance for their members. If the ABA had chosen to do this, it could have offered its members insurance at premiums lower than any other bar association, perhaps the lowest premiums of any group in the country. The ABA members, however, have chosen a more generous approach, allowing the Endowment (rather than the ABA) to operate the insurance program and retain the dividends. This approach is costly to the members who buy the insurance because they are required to pay much more than if the ABA were operating the program as a service. The program is also very costly to those members who do not participate in the ABE insurance plans because they are foreclosed from considering the cheaper insurance that would otherwise be available.<sup>7</sup> Yet, over the years there has been sur-

<sup>7</sup> The money that could have been saved by the members who bought insurance was equal to the dividends refunded minus the Endowment's operating expenses. This amounted to several million dollars a year. See p. 5 *supra*. Only about

prisingly little dissent. While a handful of members have voiced a preference for lower-priced insurance, there has never been any organized effort to change the existing policy.

Defendant suggests that ABA/ABE members have no control over the way the insurance programs are operated because the programs are maintained in their present form by an unresponsive leadership. The court finds to the contrary. In the first place, there is nothing to suggest that the ABA/ABE leadership is unresponsive to the wishes of the members they represent. While support for the current method of operating the programs is strong among ABA/ABE officials, this appears to be in great part a reflection of the membership's view. If the ABA/ABE leadership determined that a majority of the members wanted a change, there is every reason to believe that the leadership would take appropriate steps to implement it.<sup>8</sup> Moreover, even if one were to assume that the ABA/ABE leadership is unresponsive, it is not at all clear that it could stifle a grassroots movement to change the method of operating the insurance programs. Plaintiff has demonstrated to the court's satisfaction that there are ample, effective channels

---

one-sixth of the members bought any insurance, however, and few of those took advantage of all the programs available. The cost to the nonparticipating members, many of whom had to buy more expensive insurance elsewhere, is not so easily quantifiable but could be many times greater than the losses suffered by the insured members.

<sup>8</sup> If the insurance programs were to be operated in a service-oriented fashion, it might be necessary to withdraw them from the ABE and have the ABA operate them directly. See Treas. Reg. § 1.501(c)(3)-1(c)(1) (1959).

within the ABA for members to make their views known and have them implemented.<sup>9</sup>

When taken together, these factors make it impossible to conclude that the insurance programs were operated by ABE in a competitive, commercial manner. The Endowment raised huge sums of money by its activities, sums wholly unrelated to the value of any service it provided and which dwarfed the profit margins of insurance-related businesses. It disclosed the relevant facts to its members at every available opportunity, yet the members (who bore the economic cost of this program) allowed the practice to continue although they collectively had the power to change it. No business could operate in this fashion. Supermarkets would go broke if shoppers could approve prices; airlines would never leave the ground if passengers could decide what the fares should be; automobile rental companies would be driven out of business if customers could set the rates. By the same token, neither consumers nor the competitive marketplace long tolerate business enterprises that make huge profits without delivering commensurate value in return. See, e.g., p. 8 & n.6 *supra*. One would

---

<sup>9</sup> For an instructive illustration of how an attorney organization can override a decision made by its leadership see, *D.C. Bar Petitions Court to Increase Dues Ceiling*, B. Rep., Mar. 1980, at 1-12; *The Referenda are Coming*, B. Rep., Oct.-Nov. 1980, at 1-9; and *Referendum Results Tabulated; Board of Governors Submits Material to D.C. Court of Appeals*, District Lawyer; Jan.-Feb. 1981, at 20, 50-60. These articles chronicle the successful efforts of the D.C. Bar's rank and file to limit dues increases proposed by the leadership and to restrict the bar's functions in contravention of the leadership's wishes. Defendant has suggested no reason why the ABA members could not equally well overcome any intransigence on the part of the ABA leadership.

have to assume that ABA/ABE members have been subject to an epidemic of irrationality in permitting themselves to be bilked in this manner for almost three decades. The far more reasonable explanation is that the members are entirely rational and are permitting the ABE to collect such substantial revenues at their expense because they consider the Endowment to be engaged in fundraising, which they support. By any standard, an enterprise that depends on the consent of its customers for its profits is not operating in a commercial manner and is not a trade or business.

This conclusion is supported by the language of the statute. The amount of money ABE is permitted to retain far exceeds the value of any service it may be providing through the operation of the insurance programs. It is quite obvious, then, that this money was not earned "from the sale of goods or the performance of services," 26 U.S.C. § 513(c) (1976), but for some other reason. That reason was the intent of the members to support the Endowment's charitable activities.

3. Defendant argues that the Endowment's activities must be deemed a business under *Disabled American Veterans* because the rates it set for insurance were within the competitive range in the market. Defendant reads *Disabled American Veterans* far too narrowly.<sup>10</sup>

---

<sup>10</sup> The record does not, in any case, fully support defendant's factual contention. As will be discussed more fully below, see pp. 16-17 *infra*, it is impossible to isolate a single market for insurance. The cost of insurance depends on a variety of factors, many of them individual to each buyer. Thus, while ABE insurance may have been within the competitive range for some potential buyers it was not for others.



Nothing in *Disabled American Veterans* suggests that price disparity is the only factor the court may consider in differentiating a fundraising activity from a business. The broad teaching of *Disabled American Veterans* is that the court should compare the operation of the activity in question with normal business practices to determine whether the enterprise is being run in a commercial fashion. If an aspect of the operation appears inconsistent with normal business practices and the difference can only be explained by an intent to benefit a charity, the enterprise may well be a fundraising activity and not a business. Here, the fundraising activity is operated so differently from that in *Disabled American Veterans* that the comparison of the rates charged with others available in the market proves not to be a decisive factor. The premise of a business transaction is negated by the fact that ABA/ABE members as a group have permitted the Endowment to collect exorbitant revenues when they could easily deny it *any* income if they so desired.

Equally unavailing is defendant's argument that the Endowment's professional marketing and efficient administration of the insurance programs renders the activity a trade or business. Defendant's own expert economist testified that good organization and effective advertising does not distinguish a charitable enterprise from a commercial one. Fundraising, like any other activity, depends upon sound organization for success. See generally Shapiro, *Marketing for Nonprofit Organizations*, Harv. Bus. Rev., Sept.-Oct. 1973, at 123. Promotion in particular has become a recognized and important aspect of modern fundraising. Once the ABA/ABE members allow the En-

dowment to raise funds through the operation of the insurance program, the organization must do whatever is necessary to maximize the revenues derived therefrom: The Endowment's leadership would be remiss if it did less. It would be entirely inappropriate for ABA members to give up the opportunity to obtain the lowest group rates and then have the benefits of their generosity squandered because the Endowment did not do what was required to maximize the amount raised for charitable purposes.

4. Defendant cites a number of recent decisions holding that operation or sponsorship of insurance programs by tax-exempt organizations constitutes a trade or business. See *Carolinas Farm & Power Equipment Dealers Association v. United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *Professional Insurance Agents v. Commissioner*, 78 T.C. 246 (1982). See also *Long Island Gasoline Retailers Association v. Commissioner*, 43 T.C.M. (CCH) 815 (1982) (issue conceded by petitioner). These cases are not on point.

The organizations sponsoring the insurance programs in each of those cases were business leagues exempt from taxation under section 501(c)(6); ABE is a charitable organization exempt under section 501(c)(3). Business leagues are not charities as that term is generally understood; they are operated to promote the parochial interests of their members, not those of the public at large. Such organizations provide a variety of services to their members, generally financed through dues or other direct contributions. Payments to such organizations have a business purpose and are not charitable in nature. Congress has

recognized this by providing that payments to 501(c)(6) organizations may not be deducted from gross income as charitable contributions, while those to 501(c)(3) organizations may. 26 U.S.C.A. § 170(c) (West 1978 & Supp. 1983). At the same time, dues payable to 501(c)(6) organizations are generally deductible as business expenses. See *Smith-Bridgman & Co. v. Commissioner*, 16 T.C. 287, 295 (1951).

When dealing with trade associations or business leagues, therefore, the analysis of *Disabled American Veterans* is simply inapposite. Once it is shown that a 501(c)(6) organization is engaging in an income-producing enterprise, the activity must perforce be deemed a business because such organizations do not engage in charitable fundraising. By contrast, fundraising is an important and frequently continuous process for charitable organizations. *Disabled American Veterans* recognized, however, that there is sometimes a very thin line between fundraising and business activity. The court must therefore engage in a sensitive analysis of the relevant factors to determine the precise nature of the venture. Such weighing only becomes relevant if the organization is one for which fundraising is a possibility; the analysis of *Disabled American Veterans* has no bearing to the issues presented in *Carolinas Farm*, *Louisiana Credit Union League* and *Professional Insurance Agents*.

The cases cited by defendant are also distinguishable factually. In each case the organization was paid a fixed percentage of the premiums collected, ranging from 2½ to 8%. These percentages, which are well within the range normally paid for those types of promotional and administrative services, stand in stark contrast to the 40, 50 and even 90% of premiums regularly refunded as dividends and

retained by ABE. Moreover, none of the cited cases suggest that members were fully informed of the arrangement with the insurance company and permitted it to continue even though it caused them a monetary loss. In at least one case the court found to the contrary. *Professional Insurance Agents*, 78 T.C. at 251-52. In short, each of the cases cited discloses a situation where the insurance plans and related activities were conducted precisely as one would expect a business to operate.<sup>11</sup> Therefore, even if the test enunciated in *Disabled American Veterans* were applicable to 501(c)(6) organizations—which the court believes it is not—there would be no inconsistency between the results reached here and those reached in the cases cited by defendant.

5. Because this case presents an unusual fact situation, not squarely controlled by either the language of the statute or by case precedent, it is appropriate to consider the legislative history of the UBIT to determine whether the arrangements here run afoul of the congressional purposes in imposing the tax. Since the Court of Claims analyzed the legislative history of the UBIT in *Disabled American Veterans*, 227 Ct. Cl. at 478-79, there is no reason for doing so again. It is sufficient to note that, based upon its examination, the court found as follows:

The legislative history of sections 511-13 demonstrates that Congress perceived the tax-free operation of an unrelated trade or business by an

<sup>11</sup> The court in *Carolinas Farm* specifically so found, reserving the question of whether it would have reached a different result if the organization had not been operating in a commercial manner. 699 F.2d at 170 n.5.



exempt organization to provide an unfair advantage over competitors. The primary purpose for subjecting unrelated business income to taxation was to remove this unfair competitive edge.

*Id.* at 479 (footnote omitted). The court must therefore determine whether the ABE's activities have an anticompetitive effect or otherwise place tax-paying enterprises at an unfair disadvantage.

In attempting this analysis one encounters the problem of determining in what market ABE was operating and who its potential competitors were. This differs from many cases involving the UBIT where effects upon competition can be readily ascertained. *See, e.g., Carle Foundation v. United States*, 611 F.2d 1192 (7th Cir.), *cert. denied*, 449 U.S. 824 (1980) (sale of pharmaceuticals); *Cooper Tire & Rubber Co. Employees' Retirement Fund v. United States*, 306 F.2d 20 (6th Cir. 1962) (leasing of tire manufacturing equipment); *American College of Physicians v. United States*, 3 Cl. Ct. 531, *appeal docketed*, No. 84-715 (Fed. Cir. Dec. 20, 1983) (publication of advertising); Rev. Rul. 79-361, 1979-2 C.B. 237 (operation of miniature golf course); Rev. Rul. 55-449, 1955-2 C.B. 599 (construction and sale of houses). It is also not without significance that for 21 years the Internal Revenue Service took the position that ABE's operation of the insurance program was not taxable. *See* I.R.S. Letter Ruling 8042012 (July 3, 1980) (citing unpublished technical advice memorandum of January 31, 1973, that concluded ABE's insurance program was not a business). This suggests that whatever UBIT policies the ABE's activities are thought to implicate must be subtle indeed.

The Endowment was not in the business of underwriting insurance; this function was performed by two large insurance companies, New York Life and Mutual of Omaha. Moreover, when viewed from the perspective of insurance carriers, the ABE's activities were procompetitive. As previously noted, there was a constant tension between the Endowment, which wanted to set premiums high to maximize dividends, and the underwriters, which wanted to keep the premiums low to attract more members into the program. By keeping premiums high, the Endowment diminished the amount of business flowing to the two underwriters from ABE members, presumably dispersing that business to other insurance companies. Had the program been operated entirely as a service, offering the lowest possible rates, many more members would have joined the program and there would have been greater concentration of business in the two insurance carriers.

The Endowment does, of course, act as an intermediary between its members and the insurance companies. Yet, given the characteristics of group insurance, there can be just one such intermediary. The only way in which ABA members could take advantage of the benefits of group membership (either for themselves or for charitable purposes) was to have an intermediary negotiate the best possible deal for the group as a whole. ABE performed that function and there could be no second such intermediary acting for the group as a whole. To be sure, there were others competing for the opportunity to act as intermediaries for individual members of the ABE. These intermediaries would not, however, be in direct competition with the ABE for the business of the group as a whole. In any case, ABE's

insistence on large dividends, which generated the income the government now wants to tax, increased the competitive advantage of these other intermediaries. Over 80% of ABE members bought no insurance through the Endowment, most of them presumably obtaining insurance through other intermediaries. A change in ABA's policy that would make the insurance available to members at the lowest possible group rates would drain much business from these other intermediaries.

The absence of any identifiable business over which the ABE is able to gain an unfair advantage supports the conclusion that its activities are not commercial and therefore not a business. At the very least, it suggests that nothing in the policies underlying the UBIT requires that the Endowment's activities be taxed. Indeed, it appears that the Endowment's activities have an entirely procompetitive effect, fully consistent with the policies of the UBIT. The congressional purpose behind the statute would therefore not be served by holding that the Endowment was engaging in a business activity by operating the insurance program.

#### B. THE INDIVIDUAL PLAINTIFFS

The plaintiffs in Nos. 163-83T, 190-83T, 320-83T and 351-83T are ABE members and their wives. Each member has participated in one or more of the ABE insurance plans and has taken a charitable deduction for dividends refunded on his behalf by the insurance companies but retained by the Endowment. Plaintiffs claim a deduction on the theory that each payment to ABE constituted a dual payment: part for insurance and part as a contribution to the Endowment's charitable endeavors. They claim that the

portion representing a charitable contribution is properly measured by the amount of the premium refunded as a dividend and retained by ABE. Defendant argues that the payments made by plaintiffs were entirely for insurance and that plaintiffs are therefore not entitled to a charitable contribution deduction for any portion of the payments.

#### 1. The Legal Standard

It is well established that a payment can consist of two components, one that is commercial in nature and another that is a charitable donation. *See Singer Co. v. United States*, 196 Ct. Cl. 90, 109 (1971); *Oppewal v. Commissioner*, 468 F.2d 1000, 1002 (1st Cir. 1972); *Arceneaux v. Commissioner*, 36 T.C.M. (CCH) 1461, 1464 (1977); *Murphy v. Commissioner*, 54 T.C. 249, 253 (1970); Rev. Rul. 68-432, 1968-2 C.B. 104. To establish a dual payment, the taxpayer must demonstrate that he bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise. Rev. Rul. 67-246, 1967-2 C.B. 104, 105. A corollary to this rule is that there can be no dual payment where the entire amount paid by the taxpayer is economically motivated, that is, where the payment is made to obtain goods or services for which the taxpayer would be willing to pay the full price even absent the charitable contribution. *See, e.g., Arceneaux*, 36 T.C.M. (CCH) at 1464 (payment by adoptive parents to adoption agency not a contribution); *Werbianskyj v. Commissioner*, 34 T.C.M. (CCH) 467, 468 (1975) (payment for girl scout cookies not a contribution absent showing that price exceeded product's fair market value).



Normally, a determination of whether the payment for a good or service exceeds what the buyer would have been willing to pay in a purely commercial transaction is made by reference to the commodity's market value. Market value can be determined by various techniques, a preferred one being to compare market transactions for similar goods or services. *See, e.g.,* Rev. Rul. 80-233, 1980-2 C.B. 69. The valuation of insurance is more difficult. Unlike other types of goods or services that have more or less the same value regardless of who is the buyer, the cost of insurance varies drastically with the identity of the insured. Thus, for example, \$100,000 of life insurance will (all other things being equal) be much less expensive for a healthy, 30-year old, nonsmoker of normal weight than for a 50-year old cigarette smoker who is obese and has a history of heart disease.

The value of insurance also turns on factors that are not specific to individual buyers. One important factor is whether the insurance policy is an individual one or part of a group plan. Group insurance frequently is limited as to the type and maximum amount of coverage available. The subscriber must also remain a member of the group to continue participation in the group policy. The terms of a group plan may be altered by the group without the consent of the individual insured. On the other hand, group plans frequently offer attractive rates. Group plans also generally provide some level of insurance without proof of insurability and additional levels of insurance with only a limited inquiry and without a physical examination.

Group plans offer attractive premiums for many people but they do not offer the lowest premiums for all members of the group. Because individual

insurance coverage can be geared to a person's health status and other individual characteristics, people qualifying for preferred risk rates may be able to obtain individual insurance that is less expensive than group insurance. Individual insurance also provides the option of buying virtually unlimited coverage and tailoring a policy with such frills as waiver of premium, double indemnity and insuring one's insurability. The benefits under an individual policy cannot be changed except pursuant to its terms or with the consent of the insured. In addition, individual policies are available not only as term insurance but also, in the case of life insurance, as whole life. Many insurance buyers find the forced-savings and safe-investment features of whole life insurance attractive. Group life insurance plans offer only term insurance.<sup>12</sup>

Another important factor to consider in valuing life insurance is the identity of the carrier. Some insurance companies are more reputable than others; some pay claims liberally while others are more conservative. Such differences influence buyers of insurance in the selection of their coverage. Geography also has an effect upon the price of insurance. For reasons that are not entirely clear, there is no national market for insurance; the availability and cost

<sup>12</sup> While it is difficult to generalize, it is fair to say that group insurance is likely to be most attractive to people who prefer relatively small amounts of coverage, those who are subject to some risk which precludes them from obtaining individual insurance at preferred rates and those who prefer not to deal directly with insurance agents or be bothered with intrusive health questionnaires or medical examinations. All things being equal, however, a person eligible for both individual insurance and group insurance at the same price is likely to select the individual insurance because of the additional security and flexibility afforded by individual policies.

of insurance can vary significantly depending upon the place where the insured resides.

To establish that a portion of the payment for ABE insurance is a charitable contribution, a plaintiff must show that an equivalent insurance product was available to him for a lower price<sup>13</sup> and that he by-passed that product because he wished to make a charitable contribution to the Endowment. A plaintiff's mere awareness that a portion of his payment would be devoted to charitable purposes is not sufficient to establish that he made a charitable contribution. Only if the plaintiff passed up an economically more attractive package in order to participate in the Endowment's insurance program can the court find that there has been a dual payment.

Plaintiffs argue that such a painstaking inquiry for each insured member is inappropriate because the value of the insurance provided through the ABE was the net cost charged by the underwriter (the gross premium minus the dividend). They base this argument on the fact that ABE members can change the arrangement at any time, thereby depriving the Endowment of the dividends. *See p. 10 supra*. In plaintiffs' view, then, each member is entitled to deduct the dividend attributable to him because he has participated in the group decision permitting the Endowment to retain dividends and such participation establishes charitable intent. The court cannot accept this view. Whether the Endowment operates the insurance program as a service, as a business or as a fundraising activity is a group decision, deter-

<sup>13</sup> Seldom are two insurance plans identical. Any differences between the alternative insurance and that available through the Endowment would have to be factored into the valuation process.

mined by group processes; once made it is binding on all members, even those who disagree with it. The decision whether to buy insurance and/or whether to make a charitable contribution is an individual one. That the group as a whole could lower insurance rates is of little relevance to an individual member who must decide whether or not to participate in the insurance program as it is in fact structured.<sup>14</sup> For some ABE members the insurance offered through the Endowment is not a very good deal; they may choose to buy it anyway because they wish to contribute to the Endowment's activities. Other members might find the insurance to be a good value; they would buy the insurance regardless of whether they intended to make a donation. Under the applicable law, these two groups must be treated differently. An individual inquiry must be conducted as to each member to determine to which group he belongs.

Plaintiffs point to the obvious mechanical difficulties in making these determinations on a case by case basis for the 55,000 or so ABE members who participate in one or more of the insurance plans every year. They urge the advantages of a unified approach such as that adopted by Congress in 26 U.S.C.A. § 79 (West 1967 & Supp. 1983). Section 79(c) establishes uniform rates for employer funded group term life insurance. *See Table I of Treas. Reg. § 1.79-3(d)(2) (1983)*. The simplified approach of section 79 deals with a specific problem Congress recognized and chose to address. While, here too,

<sup>14</sup> Any consent to ABE's retention of the dividends that can be inferred from the fact that a member refrains from agitating for a change in ABA policies is simply too remote to establish a charitable intent.



there might be much wisdom in avoiding individual adjudication of thousands of claims as to the value of insurance, it is up to Congress, or perhaps the Commissioner pursuant to his regulatory authority, to provide such a solution. This court can only decide the cases before it and must defer to those with broader authority to address problems of broader scope.

## 2. *Application to These Cases*

No. 351-83T. Plaintiff Herbert C. Broadfoot, II, carried ABE life insurance in the amount of \$50,000. He testified that he was aware that a portion of his premium payment would go to the Endowment to support its charitable purposes. As indicated above, such knowledge is not sufficient to establish charitable intent. Nothing on the record suggests that similar insurance was available to plaintiff at a lower price and that he bypassed that opportunity in order to make a contribution to the Endowment. On the contrary, plaintiff testified that premiums for insurance offered by his state bar association were higher than for comparable ABE coverage. Since plaintiff failed to carry his burden, the court finds for the defendant.

No. 320-83T. Plaintiff Frederick G. Boynton participated in ABE's disability insurance program and was also aware that part of his premium would be used by the Endowment to support its charitable activities. The record discloses no information as to other available insurance and therefore does not support a finding that Mr. Boynton purchased ABE insurance for reasons other than his own economic interest. The court finds for defendant.<sup>15</sup>

<sup>15</sup> This plaintiff also presented an unrelated claim based on a \$50 business deduction for his membership in Eastern Air-

No. 163-83T. Plaintiff Frederick D. Turner is enrolled in ABE's group life insurance program. Like the others, he indicated that he was aware of the charitable uses to which part of his payment would be put. Here again, however, plaintiff has failed to make the necessary showing and the court finds for defendant.

No. 190-83T. Plaintiff Arthur M. Sherwood presents the most interesting and difficult case. Mr. Sherwood participated in the ABE's life insurance program by buying insurance in the amount of \$20,000.<sup>16</sup> He was also eligible to participate in the plan offered by the New York State Bar Association. For the three years here in issue, the insurance offered under that plan would have been cheaper for Mr. Sherwood. Moreover, the insurance offered under the New York State Bar Association plan was underwritten by the same insurance carrier as the ABE plan, making the two plans comparable.<sup>17</sup>

While this plaintiff, unlike the others, has established that a comparable product was available to him at a lower price, he did not state that he was aware of the existence of this product during the years in issue and decided to purchase ABE insur-

lines' Ionosphere Club which provides lounges and other facilities at various airports. Plaintiff testified that he used these facilities to work while awaiting flights. After plaintiff testified, defendant conceded his entitlement to the deduction.

<sup>16</sup> Mr. Sherwood also purchased dependent coverage through the ABE. Because the record is devoid of evidence on comparable rates for such insurance, the court finds for defendant on this point.

<sup>17</sup> While the two plans were not identical, the differences were sufficiently minor that they could be ignored or eliminated through mathematical adjustments.

ance instead because he wanted to make a charitable contribution. The court therefore finds for the defendant.

#### Conclusion

ABE's insurance program is not a trade or business taxable under the UBIT. None of the individual plaintiffs are eligible for a charitable contribution deduction on account of payments made to ABE for the purchase of insurance. Plaintiff in No. 320-83T is entitled to a business deduction of his payment to the Ionosphere Club.

No later than 12:30 p.m. on Thursday, February 2, 1984, the parties shall file a stipulation setting forth the amount of plaintiffs' judgment in Nos. 465-82T and 320-83T. Upon receipt of this stipulation, the clerk is directed to enter judgment in favor of plaintiffs in these two cases in the amounts stipulated and to dismiss the complaints in the other cases. If the parties are unable to file a stipulation, a status hearing will be held at 2:00 p.m. EST on February 2, 1984, in Courtroom No. 4, Fifth Floor, National Courts Building, 717 Madison Place, N.W., Washington, D.C. 20005.

The prevailing party in each case shall recover its costs. 28 U.S.C. § 2412(a) (Supp. V 1981); RUSCC 54(d). The plaintiff is the prevailing party in No. 465-82T and defendant is the prevailing party in Nos. 163-83T, 190-83T, 320-83T and 351-83T.

#### APPENDIX D

#### IN THE UNITED STATES CLAIMS COURT

---

Nos. 465-82T, 163-83T, 190-83T,  
320-83T, 351-83T

AMERICAN BAR ENDOWMENT, ET AL.

*v.*

THE UNITED STATES

---

[Filed Feb. 2, 1984]

---

#### JUDGMENT

Pursuant to the opinion of January 31, 1984, and the stipulation re judgment amounts filed by the parties on February 2, 1984, it was held that plaintiffs in Case Nos. 465-82T and 320-83T are entitled to recover, with the complaints in 163-83T, 190-83T and 351-83T to be dismissed.

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiff in Case No. 465-82T, American Bar Endowment, recover of and from the United States the following amounts of unrelated business income tax and assessed interest previously collected plus statutory interest as provided by law, with costs to said plaintiff:



58a

	Fiscal Year 1979	Fiscal Year 1980	Fiscal Year 1981
Tax	\$1,587,924.00	\$2,326,774.00	\$2,105,709.00
Assessed Interest	427,845.15	376,363.66	87,459.04

that plaintiff in Case No. 320-83T, Frederick G. Boynton, recover of and from the United States the sum of \$19.00 in income tax plus statutory interest as provided by law, with costs to the defendant.

IT IS FURTHER ORDERED AND ADJUDGED this date, that the complaints in Case Nos. 163-83T, 190-83T and 351-83T are dismissed, with costs to the defendant.

FRANK T. PEARTREE

Clerk of Court

By: /s/ Debra L. Samler  
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see FRAP 4(a).

59a

## APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the years at issue:

### SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

(a) *Exemption From Taxation.*—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

(b) *Tax on Unrelated Business Income and Certain Other Activities.*—An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in parts II, III, and VI of this subchapter, but (notwithstanding parts II, III, and VI of this subchapter) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

(c) *List of Exempt Organizations.*—The following organizations are referred to in subsection (a):

(1) Corporations organized under Act of Congress, if such corporations are instrumentalities of the United States and if, under such Act, as amended and supplemented, such corporations are exempt from Federal income taxes.

(2) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less ex-

penses, to an organization which itself is exempt under this section.

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

(4) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

(5) Labor, agricultural, or horticultural organizations.

(6) Business leagues, chambers of commerce, real-estate boards, boards of trade,

or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(7) Clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.

(8) Fraternal beneficiary societies, orders, or associations—

(A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and

(B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

(9) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

(10) Domestic fraternal societies, orders, or associations, operating under the lodge system—



(A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and

(B) which do not provide for the payment of life, sick, accident, or other benefits.

\* \* \* \* \*

#### SEC. 502. FEEDER ORGANIZATIONS.

(a) *General Rule.*—An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.

\* \* \* \* \*

#### SEC. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) *Charitable, Etc., Organizations Taxable at Corporation Rates.*—

(1) *Imposition of tax.*—There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a normal tax and a surtax computed as provided in section 11. In making such computation for purposes of this section, the term “taxable income” as used in section 11 shall be read as “unrelated business taxable income.”

#### (2) *Organizations subject to tax.*—

\* \* \* \* \*

(A) *Organizations described in sections 401(a) and 501(c).*—The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

\* \* \* \* \*

#### SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.

(a) *Definition.*—For purposes of this title—

(1) *General rule.*—Except as otherwise provided in this subsection, the term “unrelated business taxable income” means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

\* \* \* \* \*

(3) *Special rules applicable to organizations described in section 501(c)(7) or (9).*—

(A) In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence, the deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall be treated as not directly connected with the production of gross income.

(B) *Exempt Function Income.*—For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organiza-

tion were subject to paragraph (1)), which is set aside—

(i) for a purpose specified in section 170(c)(4), or

(ii) in the case of an organization described in section 501(c)(9), to provide for the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

\* \* \* \* \*

(4) *Special rule applicable to organizations described in section 501(c)(19).*—In the case of an organization described in section 501(c)(19), the term "unrelated business taxable income" does not include any amount attributable to payments for life, sick, accident, or health insurance with respect to members of such organizations or their dependents which is set aside for the purpose of providing for the payment of insurance benefits or for a purpose specified in section 170(c)(4). If an amount set aside under the preceding sentence is used during the taxable year for a purpose other



than a purpose described in the preceding sentence, such amount shall be included, under paragraph (1), in unrelated business taxable income for the taxable year.

\* \* \* \* \*

#### SEC. 513. UNRELATED TRADE OR BUSINESS.

(a) *General Rule.*—The term “unrelated trade or business” means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function construing the basis for its exemption under section 501 (or, in the case of an organization described in section 511 (a)(2)(B), to the exercise or performance of any purpose or function described in section 501 (c)(3)), except that such term does not include any trade or business—

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(2)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local as-

sociation of employees described in section 501(c)(4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

\* \* \* \* \*

(c) *Advertising, Etc., Activities.*—For purposes of this section, the term “trade or business” includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

\* \* \* \* \*

Treasury Regulations on Income Tax (1954 Code)  
(26 C.F.R.):

§ 1.501(c)(6)-1. *Business leagues, chambers of commerce, real estate boards, and boards of trade.*

A business league is an association of persons having some common business interest, the pur-

pose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax. Organizations otherwise exempt from tax under this section are taxable under their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

\* \* \* \* \*

§ 1.513-1. *Definition of unrelated trade or business.*

(a) *In general.* As used in section 512 the term "unrelated business taxable income" means

the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in section 512. Section 513 specifies with certain exceptions that the phrase "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 551, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511 (a)(2)(B), to the exercise or performance of any purpose or function described in section 501 (c)(3)). (For certain exceptions from this definition, see paragraph (e) of this section. For a special definition of "unrelated trade or business" applicable to certain trusts, see section 513 (b)). Therefore, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.



(b) *Trade or business.* The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross

income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

(c) *Regularly carried on—(1) General principles.* In determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities

upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

\* \* \* \* \*

(d) *Substantially related*.—(1) *In general*. Gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question—the activities, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.

(2) *Type of relationship required*. Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the

production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

\* \* \* \* \*

(4) *Application of principles*—(i) *Income from performance of exempt functions*. Gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business. The following examples illustrate the application of this principle:

*Example (1)*. M, an organization described in section 501(c)(3), operates a school for training children in the performing arts, such as acting, singing and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's



exempt purposes, it does not constitute gross income from unrelated trade or business. (For specific exclusion applicable in certain cases of contributed services, see section 513(a)(1) and paragraph (e)(1) of this section.)

*Example (2).* N is a trade union qualified for exemption under section 501(c)(5). To improve the trade skills of its members, N conducts refresher training courses and supplies handbooks and technical manuals. N receives payments from its members for these services and materials. However, the development and improvement of the skills of its members is one of the purposes for which exemption is granted N; and the activities described contribute importantly to that purpose. Therefore, the income derived from these activities does not constitute gross income from unrelated trade or business.

*Example (3).* O is an industry trade association qualified for exemption under section 501(c)(6). It presents a trade show in which members of its industry join in an exhibition of industry products. O derives income from charges made to exhibitors for exhibit space and admission fees charged patrons or viewers of the show. The show is not a sales facility for individual exhibitors; its purpose is the promotion and stimulation of interest in, and demand for, the industry's products in general, and it is conducted in a manner reasonably calculated to achieve that purpose. The stimulation of demand for the industry's products in general is one of the purposes for which exemption is granted O. Consequently, the activities produc-

tive of O's gross income from the show—that is, the promotion, organization and conduct of the exhibition—contribute importantly to the achievement of an exempt purpose, and the income does not constitute gross income from unrelated trade or business. See also section 513(d) and regulations thereunder regarding sales activity.

(iv) *Exploitation of exempt functions.* In certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles which are capable of being exploited in commercial endeavors. Where an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of unrelated trade or business. The application of this subdivision is illustrated in the following examples:

\* \* \* \* \*

*Example (1).* U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers. The endorsing of laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted U. Accordingly, the income derived

from the sale of endorsements is gross income from unrelated trade or business.

\* \* \* \* \*

*Example (3).* W is an exempt business league with a large membership. Under an arrangement with an advertising agency, W regularly mails brochures, pamphlets and other commercial advertising materials to its members, for which service W charges the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of any purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business.

\* \* \* \* \*



IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1985

UNITED STATES OF AMERICA,  
*Petitioner*  
v.

AMERICAN BAR ENDOWMENT,  
*Respondent*

UNITED STATES OF AMERICA,  
*Petitioner*  
v.

FREDERICK D. TURNER *et ux.*,  
ARTHUR M. SHERWOOD *et ux.*,  
FREDERICK G. BOYNTON and  
HERBERT C. BROADFOOT, II *et ux.*,  
*Respondents*

**On Petition for a Writ of Certiorari to the United States  
Court of Appeals for the Federal Circuit**

**RESPONDENTS' BRIEF IN OPPOSITION**

FRANCIS M. GREGORY, JR.  
(Counsel of Record)  
RANDOLPH W. THROWER  
MAC ASBILL, JR.  
CAREY P. DEDEYN  
SHEILA J. CARPENTER  
SUTHERLAND, ASBILL & BRENNAN  
1666 K Street, N.W.  
Suite 800  
Washington, D.C. 20006  
(202) 872-7800  
*Attorneys for Respondents*

BEST AVAILABLE COPY

700

## QUESTIONS PRESENTED

1. The appropriate question as to the American Bar Endowment is as follows:

Whether policyholder dividends assigned to the Endowment, a section 501(c)(3) charitable organization, by its insured members in a group insurance program constitute income from an unrelated trade or business when the United States Claims Court found as fact, and the United States Court of Appeals for the Federal Circuit agreed, that such dividends were *not* income earned by the Endowment from the "sale of goods or the performance of services," but, to the contrary, were received by the Endowment in a charitable fundraising activity approved of and controlled by the well-informed membership of the Endowment?

2. The appropriate question as to the four individuals claiming a charitable contribution deduction is as follows:

Whether the Federal Circuit correctly remanded the cases of the four individual insureds to the Claims Court for a determination of whether a charitable contribution deduction was appropriate in light of "all the pertinent circumstances" involving the relationship between the four insured members and the Endowment, including the motivation and intent of each individual claiming a charitable deduction?



### STATEMENT REQUIRED BY RULE 28.1

The American Bar Endowment is a non-stock membership corporation. Its membership consists of all members in good standing of the American Bar Association. It has no parent and no subsidiaries.

The individual insureds and their spouses who are respondents in this Court are: Frederick D. Turner and Margaret S. Turner, Arthur M. Sherwood and Karen H. Sherwood, Frederick G. Boynton, Herbert C. Broadfoot, II and Nancy L. Broadfoot.

### TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED .....	i
STATEMENT REQUIRED BY RULE 28.1 .....	ii
TABLE OF AUTHORITIES .....	iv
OPINIONS BELOW.....	1
STATUTES INVOLVED .....	2
STATEMENT OF THE CASE .....	2
Introduction .....	2
Supplementary Statement .....	3
A. The ABE Charitable Fundraising Plan .....	3
B. The Individual Insureds .....	7
SUMMARY OF ARGUMENT .....	8
REASONS FOR DENYING THE WRIT .....	10
I. The Unrelated Business Income Issue .....	10
II. The Charitable Contribution Issue .....	18
CONCLUSION .....	23
APPENDIX A .....	A-1
APPENDIX B .....	B-1
APPENDIX C .....	C-1

## TABLE OF AUTHORITIES

Cases:	Page
<i>Carolinas Farm &amp; Power Equip. Dealers Ass'n v. United States</i> , 699 F.2d 167 (4th Cir. 1983), <i>rev'g</i> , 541 F. Supp. 86 (E.D.N.C. 1982) .....	12, 13-14
<i>Louisiana Credit Union League v. United States</i> , 693 F.2d 525 (5th Cir. 1982), <i>aff'g</i> , 501 F. Supp. 934 (E.D. La. 1980) .....	12, 13
<i>Professional Ins. Agents v. Commissioner</i> , 726 F.2d 1097 (6th Cir. 1984), <i>aff'g</i> , 78 T.C. 246 (1982) .....	12-13
<i>Sedam v. Commissioner</i> , 518 F.2d 242 (7th Cir. 1975) .....	20
<i>Singer Co. v. United States</i> , 449 F.2d 413 (Ct. Cl. 1971) .....	20, 21
<i>Stubbs v. United States</i> , 428 F.2d 885 (9th Cir. 1970), <i>cert. denied</i> , 400 U.S. 1009 (1971) .....	20, 21
<i>United States v. American College of Physicians</i> , <i>cert. granted</i> , 53 U.S.L.W. 3911 (U.S. July 1, 1985) (No. 84-1737) .....	17-18
<i>Internal Revenue Code and Rulings:</i>	
Section 170 .....	2, 20
Section 501 (c) (3) .....	i, 14, 15
Section 501 (c) (6) .....	14, 16
Section 512 (a) .....	10
Section 513 .....	16
Section 513 (c) .....	<i>passim</i>
Rev. Rul. 67-246, 1967-2 C.B. 104 .....	19
Rev. Rul. 68-432, 1968-2 C.B. 104 .....	19
<i>Supreme Court Rules:</i>	
Rule 28.1 .....	ii
Rule 34.1. (g) .....	2

IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1985

No. 85-599

UNITED STATES OF AMERICA,  
 v. *Petitioner*

AMERICAN BAR ENDOWMENT,  
*Respondent*

UNITED STATES OF AMERICA,  
 v. *Petitioner*

FREDERICK D. TURNER *et ux., et al.*,  
*Respondents*

On Petition for a Writ of Certiorari to the United States  
 Court of Appeals for the Federal Circuit

## RESPONDENTS' BRIEF IN OPPOSITION

Respondents American Bar Endowment ("ABE" or "Endowment") and Frederick D. Turner, *et al.* (also referred to as "individual insureds") respectfully request that the Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit be denied.

## OPINIONS BELOW

The Government failed to append to its Petition the two oral opinions of the United States Claims Court, despite the fact that Chief Judge Kozinski viewed them as part of his opinion<sup>1</sup> and the parties had reproduced

<sup>1</sup> "The court made oral findings of fact on the record after trial. This opinion supplements those findings as appropriate to the resolution of the legal issues discussed." (P. App. 26a n.1)



each as an "oral opinion" of the Claims Court in the Joint Appendix filed in the Federal Circuit. (C.A. App. 763-825) The oral findings with respect to the Endowment, delivered at the close of trial on November 11, 1983, are set forth in Appendix A to this Opposition ("App. A"); those with respect to the individual insureds, delivered at a status call on December 21, 1983, are set forth in Appendix B ("App. B").<sup>2</sup>

### STATUTES INVOLVED

The Government failed to note that section 170 of the Internal Revenue Code of 1954 is involved in this Petition. The relevant portions of section 170 are set forth in Appendix C.

### STATEMENT OF THE CASE

#### Introduction

The Government, in its Statement of the Case, omits critical facts and obscures others; the Petition does not contain "all that is material to the consideration of the questions presented." (Rule 34.1.(g)) Specifically, the Petition fails to apprise this Court of the fact that, after a hotly contested trial nearly four weeks in length that addressed numerous disputes of material fact involving 25 witnesses and hundreds of exhibits, the Claims Court entered specific findings of fact resolving against the Government the key factual issues presented to it. The Claims Court's findings of fact were not challenged by the Government before the Federal Circuit and were unanimously confirmed by that court. It is not feasible or even appropriate in this Opposition to present a comprehensive review of the factual findings. Our supple-

<sup>2</sup> The following additional abbreviations are used in this Opposition: "C.A. App." refers to the Joint Appendix filed with the Federal Circuit; "P. App." refers to the Appendix to the Petition ("Pet.").

mentary statement attempts to highlight the important elements underpinning the opinions below.

### Supplementary Statement

#### A. The ABE Charitable Fundraising Plan

In the 1950's, the Endowment, at the suggestion of the American Bar Association ("ABA"), undertook a novel charitable fundraising plan through a group life insurance program that was designed to generate sufficient contributions to enable the ABE to further its charitable objectives. (P. App. 26a-27a) As an integral feature of the charitable fundraising plan and as a condition for participation, Endowment members agreed to assign their proportionate share of policyholder dividends as contributions to the Endowment. (P. App. 32a)

The insurance offered through the Endowment's program is professional association group insurance—a new concept in 1955 but a common one today. (P. App. 35a; C.A. App. 236-37, 243-44) Such plans are generally used to provide low cost insurance as a service to members. (P. App. 38a) For example, both the medical and engineering professions provide their members with low cost group insurance by this method. (C.A. App. 256-57, 267-70) Under such an arrangement the association serves as the group policyholder. One or more insurance companies underwrite the plans of insurance, and there may be a broker or agent of record. The necessary administration of the insurance program is accomplished by the association and/or by a third party administrator; on some plans the insurance company provides administrative services. (C.A. App. 253-56, 319-20)<sup>3</sup> Pol-

<sup>3</sup> During the years in issue, New York Life and Mutual of Omaha were the insurers for the life and accident and health insurance programs, respectively, and the Endowment employed a licensed insurance broker (James Group Service, Inc.) which received a negotiated commission from the insurance companies for its serv-

icyholder dividends paid by the insurance company (which are unnecessary insurance premiums (Pet. 3)) normally are returned tax free to the members of the association either in the form of a cash distribution or a credit toward future premiums.

The Endowment's plan, however, is different from other professional association plans. Participating ABE members pay premiums much higher than necessary to obtain the insurance coverage; they allow policyholder dividends resulting from the excess premiums to be retained by the Endowment (after the expenses of administering the plan are deducted) and used for charitable grants in the field of law. (P. App. 32a-33a, 36a-40a)<sup>4</sup> Although there was a factual dispute at trial as to the origin, purposes and nature of the Endowment's insurance program, the Claims Court resolved this dispute, finding that the program was devised as a means for charitable fundraising and "has been so presented and perceived from its inception," and further finding that the Endowment has "stubbornly adhered to the original concept that its plans are exclusively for fundraising." (P. App. 35a-36a)

The Claims Court found as a fact that the Endowment did not function either as an insurer or as a broker. Despite the Government's repeated assertions to the con-

---

ices. (P. App. 3a-4a, 27a) The Endowment administered the insurance program. (P. App. 4a)

<sup>4</sup> At the time of trial, the Endowment had made grants totaling over \$63 million to recipients including the American Bar Foundation, the ABA Fund for Public Education, the Institute for Judicial Administration, the Institute for Court Management, the National College of District Attorneys, the National Council of Juvenile and Family Court Judges, the National College of Criminal Defense Lawyers, the National Institute for Trial Advocacy, and the National Legal Aid and Defender Association. (C.A. App. 116-17) In its fiscal years 1979, 1980 and 1981, the Endowment made grants totaling \$3,602,462, \$4,397,619, and \$4,640,000, respectively. (C.A. App. 117)

trary, the Court found that the Endowment did not sell insurance. (P. App. 27a, 47a) The Government contended at trial that the Endowment, purportedly acting as a "middleman" or a "retailer", received payments of some sort from the insurance carriers for services rendered, but the Claims Court rejected this argument and expressly found that the policyholder dividends came from the members:

All of the evidence on both sides makes it clear that the money here came from premiums, that no matter what the flow of dollars the economic reality was that these were the members paying money to the association and not insurance companies paying the group in some fashion.

(App. A-12) The Claims Court found as fact that the amounts received by the Endowment did not constitute income "from the sale of goods or the performance of services":

The amount of money ABE is permitted to retain far exceeds the value of any service it may be providing through the operation of the insurance programs. It is quite obvious, then, that this money was not earned "*from the sale of goods or the performance of services,*" 26 U.S.C. § 513(c) (1976), but for some other reason. That reason was the intent of the members to support the Endowment's charitable activities.

(P. App. 41a) (Emphasis added.)

The Government did not challenge this finding before the Federal Circuit, ignoring it there as it has ignored it here. Even so, the Federal Circuit reviewed the evidence of record and confirmed the findings of the Claims Court, remarking that "the Claims Court specifically and permissibly rejected the Government's contention that the dividends represent a payment for the Endowment's services." (P. App. 11a)



The Claims Court found that the significant policyholder dividends generated by the interaction of the excellent mortality and morbidity experience of Endowment members, together with the decision to set premiums at levels significantly higher than necessary, reflected the charitable fundraising strategy of the Endowment and the expectations of the ABE membership.<sup>5</sup> In other words, the ABE membership wanted the program to work as it did and wanted the dividends to remain with the Endowment for charitable purposes. (P. App. 35a-40a; App. A-9)<sup>6</sup>

Despite the Government's attempts at trial to prove the contrary, the Claims Court explicitly found that ABE members were fully and fairly informed in a variety of ways as to the charitable purposes of the insurance program:

<sup>5</sup> The Government's repeated characterization of policyholder dividends assigned to the Endowment by insured members as "income" and "profits" begs the question. The trial in this case was directed to the factual dispute as to whether such dividends constituted "income" or "profits" from the sale of goods or the performance of services or whether there was another explanation, namely, the intention of the membership to allow the Endowment to retain the dividends (after deducting the expenses of administering the program) for charitable purposes. On the basis of the evidence at trial, the Claims Court found that the latter explanation was the correct one. (P. App. 40a-41a)

<sup>6</sup> ABA/ABE members could have decided to retain the benefit of their favorable mortality and morbidity for themselves. The Court found (P. App. 38a), however, that ABA/ABE members affirmatively chose not to pocket the dividends but to dedicate them to charity:

If the ABA had chosen to do this, it could have offered its members insurance at premiums lower than any other bar association, perhaps the lowest premiums of any group in the country. The ABA members, however, have chosen a more generous approach, allowing the Endowment (rather than the ABA) to operate the insurance program and retain the dividends.

[The Endowment] disclosed the relevant facts to its members at every available opportunity, yet the members (who bore the economic cost of this program) allowed the practice to continue although they collectively had the power to change it.

(P. App. 40a; App. A-7 - A-9)<sup>7</sup> The Claims Court also found as a fact, again contrary to the Government's assertions at trial (P. App. 39a), that the attitude of the ABA/ABE leadership toward the program reflected the views of the membership and that, if the members had wanted to discontinue the charitable feature and retain the dividends for themselves, the leadership would have responded by implementing those wishes:

Plaintiff has demonstrated to the court's satisfaction that there are ample, effective channels within the ABA for members to make their views known and have them implemented.

(P. App. 39a-40a & n.9) (Emphasis added.)<sup>8</sup>

### B. The Individual Insureds

The Government ignores the fact that the brief testimony of the individual insureds in support of a deduction was supplementary to and based upon *all* of the testimony at trial concerning the relationship of the Endowment

<sup>7</sup> The Court found that "both the ABE leadership and the insured members considered the insurance program a fundraising activity and treated it as such." (P. App. 36a) "Most professional associations (including almost all bar associations) operate such programs on a service-oriented basis and secure the most economical group insurance for their members." (P. App. 38a) "The money that could have been saved by the members who bought insurance was equal to the dividends refunded minus the Endowment's operating expenses. This amounted to several million dollars a year." (P. App. 38a n.7)

<sup>8</sup> Wm. Reece Smith, Jr., a former President of the ABA and of the Endowment, testified at length concerning the governance of the ABA and ABE. (C.A. App. 198-211) He and other ABA and ABE leaders noted the lack of dissent within the ABA concerning its support of the Endowment's program. (C.A. App. 188-89, 221-24)



members to the insurance program. In addition, in purporting to summarize the testimony of the individuals, the Government disregards highly pertinent, particularized evidence of charitable motivation.

Arthur M. Sherwood, as a member of the New York State Bar, had carried New York State Bar sponsored life insurance but dropped it before the taxable years involved here. He understood that the ABE program was charitable and that the (significantly cheaper) New York plan was not. Mr. Sherwood annually received notices (as did all insured members) from the Endowment informing him of the portion of his premium that was a contribution to the Endowment. He testified that he intended and expected that a substantial portion of his ABE premium would go to charity. (C.A. App. 413, 415-18)

Herbert C. Broadfoot testified that he believed he was making a dual payment: "One component is the insurance coverage aspect of it, and another component is the contribution that I am making to the American Bar Endowment." (C.A. App. 395) Although it was cited in our brief to the Federal Circuit, the Government overlooked the following testimony by Mr. Broadfoot:

... I was advised by the insurance agent I consulted that the American Bar Endowment insurance program was more costly than the same coverage at his company or at other insurance companies. However, he recognized the contribution feature of this insurance coverage. That really was what we discussed when we reviewed the program.

(C.A. App. 393-94)

#### SUMMARY OF ARGUMENT

The contention by the Government that the Federal Circuit's decision in the Endowment's case conflicts with decisions of other Courts of Appeals is without merit. The decisions of other courts relied upon by the Government are based on findings of fact that the dollars there

in question were received by business leagues from insurance companies *in exchange* for the performance of services for such companies. The small percentages of premiums received by those associations were found by the Claims Court to be "well within the range normally paid for those types of promotional and administrative services." (P. App. 44a) The legal question addressed by those courts—whether earnings from those services nevertheless did not constitute "business" income because they lacked the requisite profit motive—does not arise in the Endowment's case. Here the Claims Court found and the Federal Circuit confirmed that the policyholder dividends the Government would tax were not income that the Endowment earned from the sale of goods or the performance of services. Instead they were attributable to the generous decision of Endowment members to support a charitable fundraising effort by allowing the Endowment to retain the dividends. Accordingly, such dividends cannot be unrelated business income.

None of the other reasons advanced by the Government for granting its Petition is meritorious. Without admitting it, what the Government is seeking from this Court is a reversal of the findings of fact on which both decisions below are based.

As to Messrs. Turner, *et al.*, the Federal Circuit has entered an interlocutory order remanding the four cases to the Claims Court for further proceedings. The Claims Court was instructed to determine if a charitable contribution deduction is appropriate for each of the four individual insureds in light of "all the pertinent circumstances" (P. App. 21a) involving the relationship between the four insured members and the Endowment, including evidence of the motivation and intent of each individual claiming a charitable deduction. No reason exists to grant the Petition; the Federal Circuit, in remanding for further proceedings, did so on the basis of traditional principles of tax law which do not conflict with any decided cases.

## REASONS FOR DENYING THE WRIT

### I. The Unrelated Business Income Issue

1. While the Petition repeatedly accuses the Federal Circuit of refusing to apply the appropriate statutory standard, in reality it is the Government which cannot afford to (and therefore never does) apply the statutory standard to the facts found below. The Endowment can be taxed only to the extent it realizes "unrelated business taxable income," which in pertinent part is defined by section 512(a) (1) of the Internal Revenue Code as—

the gross income derived by any organization from any unrelated trade or business (as defined in section 513) . . . less the deductions allowed . . . .

(P. App. 63a) A "trade or business" is defined by section 513(c) as "any activity which is carried on for the production of income *from the sale of goods or the performance of services.*" (P. App. 67a) (Emphasis added.) Absent a finding that an activity was carried on by an exempt organization (1) to produce income and (2) that such income was from the sale of goods or the performance of services, there cannot be a finding that the Endowment engaged in a trade or business.

The Petition asserts that the Endowment's "operations obviously comprised both 'the sale of goods' and the 'performance of services,'" and implies that these activities were the reason the Endowment was able to retain the dividends that the Government would tax. (Pet. 17-18)<sup>9</sup> However, both courts below rejected the Government's

<sup>9</sup> In the past the Government had flatly conceded that the Endowment does not "sell insurance." (C.A. App. 95) This inconsistency is not surprising since throughout this litigation the Government has not been able to make up its mind as to who paid the Endowment the millions of dollars it would tax, or to fix on a logical explanation of what the Endowment has done—year in and year out—to realize its "profit" (over \$63 million cumulatively) on the administration of a single group insurance program.

contention that dividends were paid to the Endowment by insurance companies or Endowment members in return for the sale of goods or the performance of services by the Endowment. (See P. App. 9a-12a, 35a-41a) The Claims Court concluded that the Endowment did not receive one penny of compensation from an insurance carrier for any reason and held unequivocally that the members of the Endowment did not assign dividends to the Endowment in exchange for the sale of goods or the performance of services.<sup>10</sup> Rather, it was the "intent of the members to support the Endowment's charitable activities" that caused the members to permit the Endowment to retain \$63 million in dividends for charitable purposes (P. App. 41a), and, as the Federal Circuit explained, the Claims Court "determined that the Endowment's receipts have far exceeded the value of any services which it might have performed in the course of its administration of the plan, and thus did not fit within the statutory definition of income from a trade or business." (P. App. 8a-9a)<sup>11</sup>

<sup>10</sup> The Government would characterize the relationship of the ABE and its insured members as one where the Endowment bought insurance wholesale and sold it to the members retail. (Pet. 17, 25) This is in sharp contrast to the findings of the Claims Court and the analysis of both courts below. New York Life and Mutual of Omaha sold the insurance and the premium payments were made by the members. In the usual service-oriented plan the dividends, after expenses, would have been returned to the members or applied for their benefit. The price to such members, after dividends, is in no sense a wholesale price. It is the price of a particular insurance product, namely, participation in an association group insurance program. The generosity of Endowment members in giving up their policyholder dividends returned by the insurance carriers does not make the "wholesale-retail" concept valid.

<sup>11</sup> The amounts the Government would tax as unrelated business income during the years in issue are five to seven times the fee (including a normal profit) that would have been charged by a third party administrator for performing the same services in those years. (C.A. App. 138-39, 373-74, 468-71, 582, 734-35, 1173-84)



2.a. The Government asserts that the decision of the Federal Circuit "squarely conflicts" (Pet. 12) with three cases from other circuits which allegedly arise "on substantially identical facts" as the Endowment's case. (Pet. 13)<sup>12</sup> Only by ignoring the unique facts of this case can the Government make such an assertion. In the trade association cases relied on by the Government, there was no question that the sums involved were received "from the performance of services." Each of those associations performed services for an insurance carrier and was paid a fee in the form of a small percentage of premiums by the insurance carrier for the performance of services.<sup>13</sup>

The principal unrelated business income issue in *Professional Insurance Agents* concerned a percentage of premiums paid to PIA by insurance carriers for its activities in connection with several different group insurance programs that it endorsed. 78 T.C. at 256. These payments were made by insurance carriers *in return for services rendered to them*.<sup>14</sup> For example, one agreement

<sup>12</sup> See *Professional Ins. Agents v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984), *aff'g*, 78 T.C. 246 (1982); *Carolinas Farm & Power Equip. Dealers Ass'n v. United States*, 699 F.2d 167 (4th Cir. 1983), *rev'g*, 541 F. Supp. 86 (E.D.N.C. 1982); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982), *aff'g*, 501 F. Supp. 934 (E.D. La. 1980).

<sup>13</sup> As noted by the Claims Court, the associations received percentages of premiums which were "well within the range normally paid for those types of promotional and administrative services, [and] stand in stark contrast to the 40, 50 and even 90% of premiums regularly refunded as dividends and retained by ABE." (P. App. 44a-45a)

<sup>14</sup> PIA also retained an "experience rating reserve" (which is not a dividend) that it received when one of the programs it endorsed was terminated. Although PIA agreed to be responsible for distributing this fund to its members, it never did so and there is no indication that PIA members knew that PIA had received and retained this fund to which they were arguably entitled. 726 F.2d at 1100-01.

with an insurance company indicated that PIA would "perform certain services on behalf of" the insurance company. 726 F.2d at 1100. The agreement further recited that *because* the services were performed on behalf of the insurance company, the association was to be reimbursed with a service fee of 6% of premiums. A 4% fee received by PIA in connection with another policy was said by the Sixth Circuit to be "[i]n return for its promotional efforts." *Id.*

In analyzing whether PIA was conducting a trade or business, the Sixth Circuit appropriately focused on the phrase "carried on for the production of income", since it was clear that the fees received were derived from the performance of services. The court asked "whether PIA has engaged in extensive activity over a substantial period of time with intent to earn a profit." *Id.* at 1102. Since the record reflected a profit motive, the tax was imposed.

The other cases are to the same effect. In *Louisiana Credit Union League*, the business league received a flat percentage of both initial and renewal premiums on insurance policies in return for "services which the League performs." 501 F. Supp. at 938. The Fifth Circuit rejected the argument that the fees derived from services were not income from a trade or business, noting that the League's contracts with the two companies indicated that the revenue was "*earned*" (emphasis in original) by virtue of the League's activities on the carrier's behalf, 693 F.2d at 531, and such activities were engaged in "over a substantial period of time with the intent to earn a profit." *Id.* at 532.<sup>15</sup>

In *Carolinas Farm & Power Equip. Dealers Ass'n*, the association received in exchange for services an "admin-

<sup>15</sup> These fees were in the form of commissions on insurance premiums and ranged from 2½ percent to 7½ percent. 501 F. Supp. at 936.

istrative allowance" from the insurance company in the amount of 7% of premiums. 541 F. Supp. at 88. The Fourth Circuit held that the plain language of the statute should control and that an activity is a trade or business "if an exempt organization conducts it for the production of income from the performance of services." 699 F.2d at 170.<sup>16</sup>

Thus, in all three trade association cases, there was no question that the income received was derived from the performance of services. The money was received from the insurance companies as fees for services rendered and the amounts received were consistent with the market value of the services. There was no suggestion in these cases that income was the result of a charitable fundraising program. The facts of these three cases and the legal analysis required by their particular facts present a stark contrast to the facts and legal analysis pertinent to the Endowment's case.<sup>17</sup>

b. The Government argues that the Federal Circuit, in finding the business league cases inapposite, "relied principally on the fact that the associations marketing the insurance there were organized as '[b]usiness leagues' exempt from tax under Section 501(c)(6), rather than as charitable or educational associations exempt from tax (as is the Endowment) under Section 501(c)(3)." (Pet. 14)

The Government misperceives the distinction drawn by the Claims Court between the section 501(c)(6) trade

<sup>16</sup> The association also received experience refunds (dividends) on its program. However, since these were passed back to the members, no unrelated business income tax was asserted by the IRS with respect to these funds. 541 F. Supp. at 88.

<sup>17</sup> The Federal Circuit, after stating succinctly that "[a] charity should not be subject to taxation merely because its charitable solicitations are successful," pointed out that this would be the result "if we adopted the IRS' reasoning in this case." (P. App. 12a)

association cases and the Endowment's case. In the former, the courts were not presented with facts where it was necessary to distinguish between the "profits" of a business enterprise and the successful result of an effort to solicit charitable contributions. In the broadest sense every charity seeks to maximize the "profits" from its charitable fundraising; this does not mean that in every case the existence of "profit" is the equivalent of income derived from the sale of goods or the performance of services.<sup>18</sup> That is why a trial was required in this case to determine whether the Endowment was running a business, and the Endowment's position prevailed. The dividends assigned by insured members to the Endowment are the fruits of a charitable fundraising effort and are not an exchange for goods sold or services rendered.

The Government also ignores the fact that the Federal Circuit relied upon the specific statutory language of section 513(c) as an independent ground for distinguishing these cases:

We note an additional ground for distinguishing these cases: the business leagues received a stipend from the insurance companies for services provided to these companies, and not merely experience dividends which their members allowed them to keep. Their profits therefore fell within the definition of "trade or business" ("income from the . . . performance of services") contained in section 513(c).

(P. App. 10a)<sup>19</sup> Neither decision below stands on the proposition that a section 501(c)(3) organization and a

<sup>18</sup> The Government's expert economist, Dr. Plotkin, testified that the maximization of revenue or profits "absolutely" did not provide a basis for distinguishing between charitable fundraising and business profits. Further inquiry was required to determine whether the funds derived were the product of a business or a charitable fundraising effort. (C.A. App. 695-97) That is precisely the question answered by the Claims Court in this case.

<sup>19</sup> Similarly, the Claims Court determined that the trade association cases "are also distinguishable factually," finding that each



section 501(c)(6) organization are to be treated differently for purposes of section 513 *if they are operating in the same manner*. Certainly the Endowment has never made any such contention. The statutory definition of a trade or business should be applied to each exempt organization and that is precisely what the Claims Court and Federal Circuit did in this case.<sup>20</sup>

3. The Government's unsupported assertion that the Endowment's case has significant administrative importance should also be rejected. The record at trial did not disclose that the members of any other professional association knowingly chose to donate millions of dollars to charity that they concededly could have caused to have been returned to themselves tax free.<sup>21</sup> Thus, it is hard to suppress skepticism at the Government's unsupported contention that hordes of members of tax-exempt organizations are now prepared to follow the practice of the members of the Endowment—which has been widely publicized for many years—and remove from their pockets dollars they have historically kept in order to donate that money for charitable uses. But if they are, they should be encouraged, in keeping with the policy of the tax laws, to donate their dividends for public charitable purposes rather than retaining them for private

association received consideration for services rendered (P. App. 44a-45a) and that "none of the cited cases suggest that members were fully informed of the arrangement with the insurance company and permitted it to continue even though it caused them a monetary loss." (P. App. 45a)

<sup>20</sup> In addition, no one has ever contended that a "destination" of income test had any relevance to this case. (Pet. 15-16) The opinions below do not embrace any such test.

<sup>21</sup> The Government disingenuously suggests that the administrative importance of this case is buttressed by the fact that most state bar associations sponsor insurance programs. (Pet. 20) The Petition fails to note that state bar programs operate "on a service-oriented basis and secure the most economical group insurance for their members." (P. App. 38a)

gain. This possibility provides no reason for granting the Petition.

4. In belittling the Federal Circuit's opinion as "whimsical" (Pet. 18), the Government chooses not to mention that the Internal Revenue Service on two occasions (1972 and 1973) ruled that the dividends received and retained by the Endowment did not constitute unrelated business income. The Claims Court, however, noted the Service's change of position:

It is also not without significance that for 21 years the Internal Revenue Service took the position that ABE's operation of the insurance program was not taxable. See IRS Letter Ruling 8042012 (July 3, 1980) (citing unpublished technical advice memorandum of January 31, 1973, that concluded ABE's insurance program was not a business). This suggests that whatever UBIT policies the ABE's activities are thought to implicate must be subtle indeed. [P. App. 46a]<sup>22</sup>

5. The Petition asserts as a reason for granting certiorari that *United States v. American College of Physicians*, cert. granted, No. 84-1737 (July 1, 1985), "is related" and "is connected" to this case. (Pet. 12, 21) In fact, the only relationship between the two cases is that both involve the same section of the Internal Revenue Code. Otherwise, as the Petition itself demonstrates, the two cases have nothing in common. *American College* raises *only* the question of whether a tax-exempt organization's income from "commercial advertising, which it concedes to be a 'trade or business,' is 'substantially related' to educational purposes" (Pet. 21), a question on

<sup>22</sup> The Federal Circuit observed that its "refusal to view the recouped dividends as payment for the Endowment's services is consistent with the IRS' own memoranda" explaining when the imposition of the unrelated business income tax is called for and when it is not. (P. App. 12a n.6)

which the lower courts disagreed. In this case, the Government correctly noted that the Endowment conceded that its insurance program was not "substantially related" to its exempt function. (Pet. 5)

*American College* presents a totally different issue from the unanimous fact-specific decision in the Endowment's case. The Government itself acknowledges that *American College* "is most unlikely to resolve the question of statutory construction presented here." (Pet. 22) As we demonstrate above, there is no "question of statutory construction presented here" if one deals forthrightly with section 513 as written by Congress and applied by the Claims Court and the Federal Circuit. In any event, the fact that *American College of Physicians* (or any other case on the Court's docket for that matter) will not govern this case hardly constitutes a reason for granting the Petition.

## II. The Charitable Contribution Issue

1. The Petition states that the Federal Circuit "stayed proceedings on remand pending disposition of this petition." (Pet. 11) This statement is an incomplete explanation of the interlocutory posture of the cases of the individual insureds. A brief review of the decisions below will help to clarify the present posture. The Claims Court declined to take an approach that would afford a deduction for all Endowment insureds, but instead promulgated a test focused solely on the fair market value of *different* insurance. The Federal Circuit concluded that the Claims Court's unitary test was too rigid, in that it failed to take into account all the facts and circumstances bearing upon the motivation and intent of individual insureds (P. App. 19a-22a) and thereupon remanded for "an examination of all the pertinent circumstances surrounding the individual transaction," including direct evidence of the motive and intent of each in-

dividual insured, to determine whether a contribution was appropriate. (P. App. 21a)

When the Government failed to seek a stay in the Federal Circuit and the individual insureds requested that proceedings on remand be instituted, Chief Judge Kozinski repeatedly urged the Government to allow the proceedings on remand to be completed so that a full record could be presented to this Court, with no delay in the filing of the Petition.<sup>23</sup> Refusing to allow this to happen, the Government appealed Judge Kozinski's denial of its motion for a stay, and the Federal Circuit then granted the stay. Presumably, the Government concluded that a final judgment in these cases, entered after an evidentiary hearing as to the charitable motivation and intent of the individual insureds, would not enhance its chances for certiorari. Certiorari is inappropriate at this interlocutory stage of the proceedings.

2. The Government ignores the Federal Circuit's discussion of the dual payment concept, which is at the heart of that court's analysis of the charitable contribution issue.<sup>24</sup> Under recognized principles governing charitable deductions in such instances, the donor must show that his or her payment was significantly in excess of the economic benefit received—the so-called *quid pro quo*. The Government disregards the significance of the findings below that the dividends assigned to the Endowment were in such amounts as to be "wholly unrelated" to the value of any services conceivably rendered by the Endowment. It argues, curiously, that this "staggering"

<sup>23</sup> Transcript of June 27, 1985 status call at 9-13, 23; Transcript of July 3, 1985 status call at 17-19.

<sup>24</sup> In asking this Court to overturn the dual payment decision below, the Government does not mention its own rulings which recognize a charitable contribution in a situation where a payment is made in anticipation of *both* an economic benefit and a charitable contribution. See, e.g., Rev. Rul. 68-432, 1968-2 C.B. 104 and Rev. Rul. 67-246, 1967-2 C.B. 104.



amount of "profit" is evidence of a business motivation. In fact, in the context of a charitable fundraising program, what this receipt of disproportionate dividends demonstrates is a dual payment, part for an economic benefit and part for charity. Endowment members have parted with dollars that would otherwise have been returned to them; since a gift has been made with adverse economic consequences, the Federal Circuit properly held that an insured member should be entitled to demonstrate entitlement to a deduction by proving that he or she had made a dual payment.

3. The Government appears to claim that the individual insureds' cases are in conflict with *Sedam v. United States*, 518 F.2d 242 (7th Cir. 1975); *Stubbs v. United States*, 428 F.2d 885 (9th Cir. 1970), *cert. denied*, 400 U.S. 1009 (1971); and *Singer Co. v. United States*, 449 F.2d 413 (Ct. Cl. 1971). A proper analysis of these cases, however, shows that the Federal Circuit's decision is consistent with each.

In *Sedam*, the taxpayer claimed a charitable contribution deduction for payments made "in consideration" for a nursing home admitting his mother as a resident. 518 F.2d at 245. The court stated that "a payment is not a contribution or gift under section 170 if it is made with the expectation of receiving a *commensurate* benefit in return . . . ." *Id.* (Emphasis added.) There was no contention by the taxpayer that a dual payment was made. He had deducted the entire payment. The Government, in relying on *Sedam*, does not deal with the fact that the Federal Circuit applied the same standard in this case (P. App. 13a-15a), nor does the Petition come to grips with the significance of the key word "commensurate" as it applies here.

In this case, the individual insureds have contributed dividends to the Endowment for charitable purposes for which they received nothing in return. The amount of

the charitable contribution was calculated *after* the insurance companies had been paid for providing the insurance coverage at prices negotiated at arms' length, *after* the broker had been paid its negotiated commission and *after* payment of the Endowment's expenses of administering the insurance program had been deducted from the dividends. In other words, after establishing the full and fair value of the benefit a member received for his premium dollars, *there was a significant amount of money left over*, which the insured members allowed the Endowment to retain for its charitable purposes.

The suggestion that *Singer Co.* conflicts with the Federal Circuit's opinion is somewhat surprising in view of the fact that the Federal Circuit *relied* upon *Singer*. (P. App. 15a-18a) In *Singer*, the taxpayer expected that sales of sewing machines to schools at less than market prices would increase future retail sales. A deduction was denied because the taxpayer failed to show that the fair market value of the anticipated economic benefit was less than the discount given to the schools. 449 F.2d at 420, 423-24.

*Stubbs* was a jury case in which the question was whether a landowner could deduct as a charitable contribution the value of land dedicated as a public road. The issue of a *quid pro quo* was put to the jury, which apparently believed the prior inconsistent testimony of the taxpayer at a hearing before the Zoning Commission that he would receive by reason of the transfer an offsetting economic benefit to an adjacent property. 428 F.2d at 887 n.1. As in *Sedam*, there was no contention that there was a dual payment.

4. The Government erroneously argues that the Federal Circuit's decision has in some way altered traditional principles of burden of proof applicable in tax refund cases by stating that such burden would shift to the Government on the deductibility issue upon presentation of a

*prima facie* case. The Federal Circuit's opinion says no such thing. Nor does the Federal Circuit suggest a "self-serving affidavit" as an appropriate way to proceed. (Pet. 24-25)

The Federal Circuit applies well-recognized concepts of shifting evidentiary responsibilities at trial to the particular circumstances of this case. It outlined those elements which for certain members would constitute a *prima facie* case for sustaining the charitable contribution deduction.<sup>25</sup> A *prima facie* case, of course, is that minimum quantum and quality of proof which, if unrebutted, would entitle the proponent to a judgment on his claim. Once the taxpayer has presented a *prima facie* case, it is only the burden of going forward with additional evidence to rebut that case which shifts to the Government. If the Government discharges its responsibility of coming forward with rebuttal proof, the taxpayer is still required to establish by a preponderance of the evidence his entitlement to the claimed deduction. This process is all that the Federal Circuit decision envisions, and nothing in its opinion offends any notion regarding the burden of persuasion in tax or other civil cases.

---

<sup>25</sup> The Government does not mention that the Federal Circuit also outlined other elements on the basis of which a "trial court might reasonably conclude" that "the taxpayer should be denied a deduction." (P. App. 21-22a)

## CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted,

/s/ Francis M. Gregory, Jr.

FRANCIS M. GREGORY, JR.  
 (Counsel of Record)  
 RANDOLPH W. THROWER  
 MAC ASBILL, JR.  
 CAREY P. DEDEYN  
 SHEILA J. CARPENTER  
 SUTHERLAND, ASBILL & BRENNAN  
 1666 K Street, N.W.  
 Suite 800  
 Washington, D.C. 20006  
 (202) 872-7800  
*Attorneys for Respondents*

Dated: November 7, 1985



# **APPENDICES**

A-1

APPENDIX A

IN THE UNITED STATES CLAIMS COURT

---

No. 465-82T

AMERICAN BAR ENDOWMENT,  
*Plaintiff,*

v.

THE UNITED STATES,  
*Defendant.*

---

TRANSCRIPT OF ORAL OPINION  
OF CHIEF JUDGE ALEX KOZINSKI  
ON NOVEMBER 11, 1983

THE COURT: Okay thank you very much. I am going to take a little break and come back with as much of a decision or perhaps an entire decision, as I can make today.

(A brief recess was taken.)

THE COURT: Please be seated.

I am going to decide Case Number 465-82T, the case of the American Bar Endowment versus the United States, in favor of the American Bar Endowment, the Plaintiff.

I have sat through three and a half weeks of trial, and have had an ample opportunity to observe witnesses, and to absorb their testimony and I have looked at as many documents as I think could [profitably] \* be looked at. And the reason I am deciding that case in favor of the American Bar Endowment is that I have determined that

---

\* Brackets indicate a correction required in the transcript.



this is not a business and is not making a profit from its enterprise.

Now, Dr. Plotkin suggested several smell tests that can be employed for that purpose, and I suppose I have used my own smell test as well as the facts.

The first factor, and one which ought not to be at all underestimated in importance, is the way the program is billed, the way it is advertised, the way it is presented, the way it is operated. The program is presented to the world and to the members in a very open fashion, as a charitable program, as a means of fundraising.

That is not determinative. The fact that the program either through subterfuge or through perhaps honest delusion is presented as a fundraising effort or the means to raise charitable funds, is not conclusive, is not binding on the Court; but I certainly think it is well worth considering as one factor.

I may be less skeptical than my brothers and sisters in the field of taxation law, but to me what people say to each other, particularly when large groups of people say it repeatedly to each other and they have a common understanding, makes a difference, makes a starting point. It raises a presumption. Perhaps not a very strong presumption, but one that I think is well worth keeping in mind as a place from which to depart.

Now, in this case we have seen a good deal of advertising and a good deal of literature, a good deal of promotional materials, ABA journal articles, reports, so on, and I find that it was made abundantly clear to the ABA membership and the ABE membership that the insurance programs were a method for fundraising. That was billed as its purpose, and this was communicated in fact to the membership; and one, of course, can never guarantee in a group of 300,000 that each and every member will unmistakably learn the precise purpose, but I find that with perhaps trivial examples, lawyers being well informed,

certainly being able to read, and there was a barrage of literature, barrage of advertising, barrage of reports which over the years should have made it abundantly clear and did make it quite clear that was the billed purpose, that was the way the program was perceived.

I also look in the smell-test category, rather than necessarily the operative fact—and it is a gray area as to where one begins and the other one ends, but I also look at the startling profitability of this group. And it has made a lot of money over the years, it has made \$63 million. That tells me two things. One of them is there was a lot of testimony about who else in this general type of enterprise or in this general field has made, or will make or can have made this much of a profit, and I think the evidence is quite clear, and in any case I so find that equivalent profits were only made by what has been described by one witness as the robber scoundrels of the insurance industry who, as I understood Ms. Khachadour and other witnesses to explain, used captive audiences, used very serious pressure tactics, used practices that can [be] viewed as entirely—or could be viewed certainly and have been viewed as unethical and have been made unlawful; such things as a person who wants to get a loan, who may be desperate for a loan, maybe something having to do with his house or who may need the loan for some other personal purpose and may be required as a condition for buying the loan to buy the insurance.

The analogy to those kinds of situations, or to that kind of an enterprise is nonexistent here. To be sure, the American Bar Endowment used advertising and something that conceivably could be viewed as scare tactics, listing the many illnesses that befall man in light of his transgression many years ago with the apple and the snake; and I suppose that is our lot, we have frail bodies and once in a while we do get reminded of the fact that the unfortunate among us can be beset with illness and death.

But that is an entirely different kind of pressure tactic than holding the necessity of a completely collateral nature, such as a loan, car or house loan, or some other transaction, hostage to the purchase of insurance.

So when we look at the question of these great tremendous profits, we have to find some other explanation as to why this particular operation has been so successful in raising funds, and once again here I reveal my lack of skepticism, perhaps, but my feeling is that the obvious explanation sometimes is the one that is correct. You know, if it looks like a duck and quacks like a duck, and you know it leaves droppings on the floor like a duck, then maybe it is a duck. And in this case the explanation that suggests itself to the mind immediately, if indeed the American Bar Endowment were selling its members—"selling," I use loosely the term, was conveying the idea that this was a fundraising enterprise and therefore rates are going to be set in accordance therewith, and that the many millions of dollars that were made from this enterprise were disclosed to the members over the years, and the profitability of the enterprise continued, the suggestion is that maybe members really thought this was a fundraising enterprise, that they were really participating in fundraising and that they tolerated this as consistent with the purpose of the effort.

That is certainly the suggestion that arises in one's minds [sic] when one looks at these factors. Nothing I have seen in this case suggests that that is different. I think it is almost bizarre to suggest that the strong fundraising aspect of the literature and of the approach, of the information conveyed, the fact that the profits, as they are called, or the result of all of these fundraising activities were disclosed and, so to speak, rubbed into the faces of the members, that it would be ignored, that it doesn't exist in reality? I simply have seen nothing in this case that suggests that those factors ought to be not taken into account.

Now, what have we got here? When I started to analyze it, I posed it as a hypothesis at various times in the trial, but now I state it as my finding: I think we have a situation here there is a group asset. There is an asset that exists only by virtue of the group.

An individual member does not have a piece of the asset in the sense that he could walk away and pocket it and use it on his own. By virtue of existing as part of a group something more is created, an economic good is created which did not exist outside the group experience. And I am not sure how to characterize this asset or what I ought to call it, but we all know, all of us who have sat here and watched for the last several weeks know the nature of the beast. It is a favorable group rating. It is the ability to bargain well with the insurance company and to get the discounts that go with being an experience rated group.

It has been described in various ways, but what it amounts to is a reality that seems to be, at least as far as this record is concerned, limited to the insurance industry. I don't say some other case might not arise that might involve a similar analogous experience in some other industry, but nothing suggests itself to the mind.

The asset is created by virtue of the fact that it is possible, or so we have learned, to segregate out of the mass marketing of insurance a group that has more favorable morbidity and mortality experience; that enables that group and its members by virtue of group membership to profit from lower rates. Or they could profit from lower rates if they don't do something to stop themselves from so profiting.

And that raises interesting questions. I wish I had had economists to discuss with me—because I am not sure anybody else here likes economists. I know Mr. Gregory is skeptical of them, but I for one enjoy listening to economists and I frequently learn. And what was



somewhat lacking on this record, and what I had to to some extent use my own imagination for is the economics of the group asset. How does one create a group asset, how does one control a group asset, how does one monetize a group asset and the various aspects of group ownership, control and distribution of whatever benefits are involved.

And absent evidence to the contrary it seems to me that an asset that is created by virtue of the existence of the group ought to belong to the group and not to any one individual member, that it is something that the group as a whole must dispose of through normal group processes. It is not, as I said, the type of asset that could be divided up and allow each person to walk away with it, it has to be dealt with in some group fashion, left to be dissipated. It seems to me group processes normally rule by majority and when the group is too large to have absolute majority rule the representative process is the way to dispose of group [assets].

To be sure there are always in the group, as there is in society, those who would deal with group problems in a fashion which is different from the majority. That is the nature of the democratic process and that is the nature of the group process. Any group larger than one has a potential for dissidence. And I don't know what one can do about it. We are all a part of groups and societies; and I don't think there is anybody here who agrees with everything our Government does in every instance, nevertheless it is our Government and it has imputed to us our action, and by the same token the group asset is disposed of by the group. In this case the group has made a decision through its membership, or its leadership to dedicate and devote the group assets for a charitable purpose. And they have chosen a way which in my view is calculated to achieve that result. And by donating the asset in total to the American Bar Endowment and allowing for it to monetize it, to in some

fashion derive from this asset the most benefit that it can for the charitable enterprise.

Now, it should be observed, and I think Dr. Plotkin agreed with me on this, from an economic standpoint the membership by making the decision has uniformly to a person made a contribution in an economic sense; by voting for this group device, for this disposition of the group asset, each and every member has been deprived of the opportunity to participate in a lower-cost insurance program, if indeed the American Bar Endowment were able to set one up.

Now, there have been some last-minute questions raised on that, and I simply cannot believe that after all of the evidence we have seen in this trial about state bars and local bars and county bars setting up group plans that there would be serious question that if the ABA membership with all of the legal talent at its disposal chose to set up a plan that would be simply a service-oriented plan that they could not figure out some way of doing it without losing the tax status of either the ABE or ABA or both.

Now, by making the decision, each and every member is contributing to the joint enterprise by agreeing to forgo the benefits, and they have been pointed out to be substantial benefits, of the much lower service-oriented group insurance.

The question then arises to what degree is there really control over the group. By the group rather, I mean over the program. And that has been raised as an issue. And I simply have seen no evidence at all suggesting that this group is any different from any other group in the ability of members to make their views known to the leadership, and to change the direction taken by the leadership when it is inimical to their understanding and interest.



I said I would take judicial notice of the events that transpired in the D. C. Bar several years ago, and in that case there was a great rift between the leadership of the Bar and the rank and file. There is great evidence that the D. C. Bar thought that the two referendums that were posed, one which would lower dues on the one hand and the other which would limit activities to the Bar, would sound the death knell to the Bar as an institution, that it would render it merely a shadow of its former self, that it was the professional responsibility to engage in other activities, that this was generally a bad idea.

There was no doubt to those of us who are in D. C., certainly not to me when I was here when this was going on, and certainly the materials don't raise any doubt, but that this was a grass roots movement versus leadership of the Bar. And when all was said and done, and when it came down to the economic interests of the Bar members and the few dollars here and the few dollars there, and the dust settled, the members of the Bar spoke loud and clear: They preferred to keep the money themselves rather than engaging in various extraneous Bar-type activities, other than the minimal ones of attorney discipline and the like. D. C. members simply did not want their Bar squandering their money, or at least they viewed it as squandering their money on public spirited types of activities, activities that would enhance the organization.

I have little reason to believe that when \$63 million are at stake that the members of the American Bar Association or the American Bar Endowment could not change that policy. Now, again I want to point out that more than \$63 million are at stake, because not only is at stake the amount that was actually collected in dividends and premium refunds, but one must also include the economic incentives and the economic benefits lost, all of the benefits that other members of the Bar who chose not to participate in insurance would have gained if only there were a change in the policy. So we are not talking

only about those who buy the insurance and forgo the premiums, but we are also talking about the significant economic incentives that exist for those who do not buy the insurance but wish they could.

I am persuaded that if the American Bar Association Plan were not viewed as a fundraising enterprise and were not viewed by the overwhelming majority of the membership as something to be tolerated as, to be sure, an economic expense but one for the good of the profession, and for the greater good of society, that it would not exist, it could not have existed, it could not have survived, it would not have survived to today. And at least on the basis of this record those are my findings on that point.

I do want to speak a little about the analysis of Dr. Plotkin, whom I certainly enjoyed hearing, and for whom I have a great deal of respect. I questioned him at some length because—well, I couldn't forego the opportunity, and because I guess I had questions that went to the heart of his analysis, or to the manner in which his analysis was constructed, and I wanted to understand what direction he came from.

Now, Dr. Plotkin was quite candid that the analysis that he employed was an industrial organization analysis. It was analysis born of antitrust. Much time is spent by economists wondering whether if one fixes prices everyone will be better or worse off, and as I recall by way of showing on that board—I am sure Mr. Gregory would want to know precisely how that is done—that if you only avoid price fixing there will be more things for more people, and things get more complex from there.

The question I asked myself is how do the underpinnings of industrial organization analysis, antitrust analysis, relate to the question in this case. And the question in this case is a rather more narrow one. We are not dealing with the broad questions of antitrust, those

questions involve very complex issues and very complex policy judgments. We are here dealing with basically the question of whether something is a business or is not a business, whether something is a fundraising activity or not a fundraising activity. We are looking to indices, but by definition that activity has to take place in the market.

And by definition, again from Dr. Plotkin's own statements, that activity, fundraising activity, must displace and must have a ripple effect upon the market in which it operates. It is almost inconceivable to have some activity that one could classify as simply fundraising that does not somehow [a]ffect other transactions in the market and other various structures of the marketplace. And I was interested to find out how those policies, how the things that Dr. Plotkin was taking into account in reaching his conclusion related to what we are talking about here.

I was a little disappointed to understand that Dr. Plotkin, while he was conversant with spaghetti—which is fine, which is really the place where the unrelated business income tax started from—was not as conversant as I well might have hoped with the policies of the unrelated business income tax. To him the fact that if one buys one brand of spaghetti one is less likely to buy another one seemed to be—I don't mean to give too little weight to his testimony, but simply that seemed to be the key for him, a question of substitution in the market. And this is simply not the way I viewed the unrelated business income tax and that is not the way I viewed the Disabled American Veterans.

The unrelated business income tax was passed to avoid a certain kind of evil. Now, we all know that one cannot use and ought not use, and I certainly will not use legislative history to go contrary to the express terms of a statute when they are clearly applicable to a situation.

But Congress was not so generous in defining for us business profit and the like. We have to make the decisions on our own, we the courts. And therefore in looking at a situation where you have a transaction where both buyer and seller are consenting in the sense that one controls the other, or one has significant control over the other, one is somewhat at a loss to see whether something is a profit. That is what we have been grappling with here for the last three weeks. So you go back and look at what evil there is in the market. What was Congress trying to do in 1950 or 1953 or when the [unrelated] business income tax was passed, and one comes to the frequently-asked question, "Who is Ronzoni."

Now, nobody has really satisfactorily pointed to Ronzoni for me. I have been listening for three weeks of trial and nobody came up and said, "Here, this is Ronzoni, this is the competitor that is going to be adversely affected in the manner in which Congress feared there would be adverse effects when it slapped Mueller Macaroni Company on the wrist,[""] or basically said you cannot do that, you cannot use your tax exempt status to make profits.

And I am still somewhat nebulous as to who Ronzoni is, as to who is hurt, who is damaged if the members of the association on the one hand allow the association to use its group asset in order to raise funds. And I don't think—you know, the most obvious Ronzonis, or the most obvious candidates are the other life insurance companies, your Prudentials, your Mutuals of New York, and the like. And all the evidence seems to be that if only ABE charged less, if only ABE charged less and perhaps charged so little as to make no return or profit or whatever one calls it, fundraising, at all, there will be more people buying ABE insurance, for many people that would then become a better deal and it would be more likely that Prudential Insurance and Mutual of New York and the like would lose business.



So in that respect the results suggested here by application of the tax at least initially looks like a perverse result. But when one thinks out loud, what else is there? I mean is there some other organization in the market, some other Ronzoni, some other enterprise that is damaged, hurt, that suffers by virtue of the fact that this charitable type enterprise is engaging in this activity. Is the evil the Congress sought to alleviate creeping in in some fashion which is not obvious to the naked eye. And it takes another look.

And the question then is what of the organization as an intermediary, or as somebody who goes and sells the group experience for insurance companies, or somehow competing perhaps with other people who would act as intermediaries to this group, or something of that sort.

And the evidence tends to strike a couple of these hypotheses out right away. All of the evidence on both sides makes it clear that the money here came from premiums, that no matter what the flow of dollars the economic reality was that these were the members paying money to the association and not insurance companies paying the group in some fashion. The evidence of the insurance people was clear, but more telling was the undisputed evidence of all of the other witnesses, Ms. Khachadour as I recall was one of them; and quite clearly insurance companies don't manufacture money, although some of us may suspect at times they do; it comes from premiums.

I don't think this is a terribly complicated transaction, I think most people know what dividends are and that basically they come from refund of the premium and the premium came from the member. So it is difficult to construct a hypothesis that somehow the group is selling something to the insurance companies.

And you get back to the question is the group profiting from its own members. And I simply was not able to

find that it is. I find that the idea of profiting from oneself, that the idea that profit given by consent, is almost a contradiction in terms.

Now, could somebody else have stepped in, or is APE precluding somebody from stepping in and taking advantage of some market opportunities, the sellers of macaroni, some sort of analogy of that sort?

The point is there is only one such group asset, only one group experience. It belongs to the group. I have seen no reason to think that it belongs to society as a whole or to individual members; nothing has been presented to suggest that it ought to belong to anybody but the group. And this situation is not like the purchase of macaroni, where basically only one entity can have the benefit of that and the group has chosen to make a gift of that group asset to the Endowment. And you know, perhaps other witnesses and other economists, on a different record, somebody will be able to point out to me Ronzoni in this picture, but I have tried very hard, and looking at the policies of the tax, the policies of the unrelated business income tax, I have not been able to find the evils that Congress sought to alleviate by passing that tax.

Therefore getting back to the analysis itself, there is nothing that would push back the original inclination I had, this is billed as a charitable enterprise, it is presented as a charitable enterprise, it is a group asset, it is given by [m]utual consent, members have control, one can't make a profit on oneself, I don't think. I think it is the antithesis of a profit to say that one can have control of how much profit we take, much like the suggestion I made to Mr. Dennis what would happen if all Safeway customers were allowed to vote on the prices at Safeway. The reason Safeway makes a profit is because customers don't get a chance to vote. And I therefore conclude that it is just not a business enterprise, by its structure, by



the way it is operated, by the way it is billed and by the reference to the policies of the tax, there was not profit and therefore not a business.

I have considerably greater trouble on the issue of the individual members, and as clear in my mind as the issue of the Endowment is, or at least the way it seems to me it is clear, I have still grave doubts on the question of the individual members, and I am not going to be able to resolve them today.

I have listened to both sides, and I have listen[ed] to both sides speak today, and perhaps the problem is the case has been tried and presented and certainly viewed by me largely with reference to the unrelated business income tax, to that aspect of the transaction, and in the fond hope that that would take care of the other problem as well. And in Plaintiff's view I know that it does. In Defendant's view I think, had the result been different on the Endowment case, I am sure they would have had the same view. I view them as not necessarily related. I recognize that is a much more difficult problem and one that I just cannot resolve today. I am simply going to have to go back and think about it.

I understand very well where the two parties are coming from. I think I understand this case as well as anybody here, because I have the benefit of not having the perspective of one party or another. And Plaintiff is saying the valuation of insurance to a group ought to be the net cost. That is a fair market value.

I understand Defendant's position equally well, that one looks at comparable sales and comparable transactions and that you don't look at cost of the product to determine its value. One can get into a bargain and buy something one day, buy a stock one day, say, and then it gets taken over, or there is an offering by some other company to buy out that stock and it immediately shoots up. Well, the fair market value of the stock is not neces-

sarily what one paid for it the day before, it is what somebody else was willing to buy it for today. Those who have bought and sold on the stock market know that. I think there are inherent and difficult inconsistencies that cannot be resolved by either position and that may be unresolvable.

I recognize that the Government has done away with, or has never really quite presented the Duberstein test; and the question is not one of good heart or generosity, but I am troubled by the position taken by the Plaintiff in offering Mr. Burnett a charitable contribution. I may decide that nevertheless Mr. Burnett ought to get one, but having seen him sitting on the stand, and being convinced that he in fact bought the insurance because it was the best deal he had, I am troubled about saying that he ought to get a charitable deduction on top of everything. I simply am convinced as to him that he is buying the insurance by virtue of the fact that it is the best deal and not because he has any attachment to the Endowment's purposes or otherwise.

I am equally troubled by the position taken by the Defendant, the suggestion that these are name tags, or books or key chains capable of valuation in one market is simply not supported by this record. I think it is utter nonsense. I think there are at least 50 markets for insurance, particularly group insurance. I think one ought to take into account the basic and significant differences between group insurance and individual insurance. I think individual insurance by clearly established record is a different product, and a significantly different product. One can take it with one to one's grave or something of that sort. Certainly to California. And it is viewed, sold, marketed and considered as a different product. There are little frills you can buy with it. You can buy double indemnity and accidental death, waiver of premium; you can insure your insurability. It is yours, you can do lots of things with it. I think the subject of valuation that

people place on having an insurance plan is not [dependent] upon a membership to [sic] an organization or that it is somehow geographically limited.

So comparison with individual insurance, although not entirely irrelevant, I think is inherently misleading, and it is very difficult to account for the subjective differences that a particular consumer of insurance would feel in having his own insurance that can't be taken away from him, that has guaranteed premiums as opposed to another insurance where he has to pay membership in an organization that may or may not exist, that may or may not expel him, that may or may not be acting in his best interest, that may or may not be in the same geographic area all the time; let's say he has to move overseas or elsewhere, there are many uncertainties connected with group insurance which are simply not present to individual insurance and I find the analogy on them on the basis of this records [sic] to be a difficult one. I don't find them incompatible, entirely irrelevant, but on the spectrum of things individual insurance is much further away from center than let's say other Bar plans or other associational insurance available.

Nevertheless the point is well taken. The market consists of lots of competing products and many of them are only imperfect substitutes for another, and yet for better or worse courts must consistently make decisions on the basis of somewhat arbitrary distinctions between valuations of one item or another; the house near the end of the block as opposed to the one in the middle of the block, the house two blocks away closer to the supermarket and across the street from the school. Courts do it all the time.

What is troubling about Defendant[']s analysis is not the idea that one ought to value some very, very subjective considerations one against the other, but the idea that there is one market, and the idea that one can find

a fair market value for insurance in the United States and place the American Bar Endowment plan either within or without that market range. And that is very troubling.

I am troubled by the gentleman or lady in New York City who is a member of those two associations and who has by hypothesis in front of himself or herself the two plans, the New York State plan and the American Bar Association Plan. I cannot on the basis of this record—I could not conclude for such individual if he or she were to come to ask for a refund in this Court and I would look at that person's situation that a decision to buy American Bar Endowment insurance is other than a gift, that it was a contribution, that it was indeed the differential was paid in order not to get insurance, but in order to get whatever satisfaction one gets from contributing.

There are the two positions. Both create unfairness and both create what I view as inconsistencies. And I know both sides feel that their view of the transaction is the only one that is acceptable. I am simply saying I am enough troubled about it that I am not going to decide today. And I am going to say this much: I am not simply withholding this issue, but I am indeed undecided. I am so close to 50-50 on the issue that I cannot personally myself tell which way I would decide the case were I to make a decision at this minute. I would probably have to throw up a coin or something close to that. I don't know if that is any help to anybody. It is not nearly as much help as getting the case decided in one's favor, but there it is.

I am fairly firm, quite firm on the Endowment side of the case. As I have said before, I consider myself infallible although not irreversible, so I think everybody should have the hope, or the appropriate amount of skepticism.



I want to suggest to the parties further possibilities of settlement. I had hinted at this before today's session. I want to now propose it outright. On the one hand, I think there are basics for settling. Nobody really knows, including myself, how I am going to come out on the members. At least Mr. Rubloff empathizes with my dilemma and I hope others too. I will decide it, one way or another I will come out with it, and if nobody suggests the middle way I will have to select one of the two positions suggested, and in light of my ruling on the other case I am going to have to go back and rethink and look at the authorities cited one more time. And I figured the first case out and I will figure this one out too for better or worse, but let me suggest the possibility that settlement may not still be beyond reach.

I have made my statement on the Endowment's case. And one should not underestimate the deference that an Appellate Court will give to a trial Judge who has sat here for three and a half weeks and looked at the witnesses and considered the evidence.

On the other hand, these are big issues. And by everybody's analysis there is really not that much in dispute. If the parties after all of this want to sit down and hammer out a stipulation, I bet you it could be done. So nobody is really going to offer me the kind of deference in a case where there are two inconsistent witnesses, one says I was home with my mother and the other says I saw them stabbing the victim. It is just not that kind of case.

I will endeavor as best I can to pull together the relevant facts as I see them, but my opinions tends [sic] to be short on facts. I tend to say only the things that I consider relevant or crucial to my decision, and I think it is fair to say that the Appellate Court will be able to make up its own mind on the analysis, the analytical portion of my conclusion. So whereas I think there is good

reason for the Bar Endowment and its members insofar as the Endowment to be heartened by my decision, there is always the possibility of reversal, and I guess I don't need to repeat that again. I think it ought to be on everybody's mind.

And then there is the question of how I am going to come out on the individual members. I have no way of knowing what is really important to the parties and what is really the telling aspects of the case, whether the members' case is more important than the Endowment case or the like. This is only something that each side can determine on its own.

But as far as the Government is concerned, I promise at least as far as the Endowment is concerned, and certainly whatever I do with the members, I will write an opinion that I hope is persuasive. I will, having once decided how the case ought to appear, I will draft it in such a manner as to maximize the chances for affirmance. Let me just say there is certainly solace to be taken from the possibility of reversal, but I wouldn't count on it. I think more likely than not appellate courts in such cases tends [sic] to give some deference.

I am going to think about this case. I have about seven trials coming up, five before the first of the year, a couple more in January, and I have three major opinions in the works. Frankly, I have spent enough time on tax for a while, and particularly on the American Bar Endowment. I am going to another trial starting Tuesday. I have got speaking engagements and trials in Houston and Lord knows. I have got a trial starting between Christmas and New Year's. So I would just as soon not think about this case for a while. And in light of all that you have learned today, and perhaps for the first time you have now had your respective views scrutinized by somebody. I hope you understand understands what you all have to say. You may not all agree with everything I



said, in fact I am sure each side disagrees with some of what I said, but I do understand your case and I do in light of the maximum amount of evidence that has been presented I think have a pretty good grasp of what went on.

So try to step back from your own position, from your own view of the case and kind of view it from my perspective, and then ask yourself is there a basis for trying to work out on the one hand securing the gains already made, and on the other hand salvaging the limiting losses that might already have been suffered.

So I think you should all go home, digest it, buy the record, buy a transcript, listen carefully to what I was saying, what I was asking, what I said this afternoon, and try to figure out how I am going to decide the other aspect of the case. And if you can, you are more clairvoyant than I am. But what I propose to do is take a little while off and work on some other cases. I simply do not at this point have the time to devote further to this case and I am going to leave it in abeyance. The other cases are lined up. And I do want to give everybody a chance to have things sink in and I would then like to request one more massive and good faith effort at settlement.

What I have said today on the record is not necessarily of precedential value. My thoughts are in the transcript. They do not embody an opinion. They are known to those present, but of course they would not be binding on anybody else. Think of the consequences of an opinion, the consequences of affirmance or reversal of the opinion, and think about the one outstanding issue; and do not minimize how difficult an issue it is. Much as everybody thinks that they are right on it, I think you fairly ought to know I am not doing this in order to in a sense extort a settlement. If I could have decided the case in its entirety today I would be entirely pleased to do so. I am

not holding back just to press settlement. I simply cannot decide it today. It is unusual for me, but I always reserve that prerogative, and when important cases come along and difficult issues, issues I cannot resolve on the spot, I want to be as candid about that as I am about telling you when I have made up my mind.

Why don't we set the case for status in about three weeks?

MR. GREGORY: I take it, Your Honor, that with four remaining cases of the individuals, you are not deciding either the New York Plaintiff cases today or the other cases?

THE COURT: I am deciding the Bar Endowment case. I am not deciding any of the individual cases. Now, in a sense there is no decision today, and there is no opinion or judgment or order or anything of that sort. I have simply made the prediction of what my opinion is going to read like. I am not going to change my mind. My mind may be changed for me but I am not going to change my mind on that one. In a sense what I was telling you is what my mind looks like at this point and I have decided in my mind the Bar Endowment case, and I will eventually have an opinion that reflects many of the thoughts I gave today orally.

I am not deciding any of the individual cases. I don't think they can be separated, Georgia, New York, though perhaps it can be, perhaps what we wind up with is some geographical nightmare where people from New York are going to be better off than people from Arkansas. I would hope that is not the result I come up with. I would hope fervently that everybody thinks about the mischief that judges can do when they start trying to work their way out of what they consider to be difficult theoretical boxes, or difficult dilemmas.

I want to be candid, this is a dilemma for me. I find that aspect of the case the most difficult part. Everything

else, judgment calls, whatever, but it finally fell into place for me. I see my way clear quite well on the Endowment. It just has not fallen into place for me as far as the members are concerned. Please don't make me make any mischief. We want the law to develop in a reasonable fashion. And consider your respective interest, consider what you think you can give up, take into account what I have said and the consequences of the ruling in this case to yourselves, to the law as a whole, to other taxpayers.

It is never too late to settle. I suppose it is too late to settle once cert is denied, but should we set—can I get the agreement of both sides you will go back, digest what I have said and make one final very serious stab at settlement?

## APPENDIX B

## IN THE UNITED STATES CLAIMS COURT

---

Nos. 163-83T, 190-83T,  
320-83T, 351-83T

FREDERICK D. TURNER *et ux.*,  
ARTHUR M. SHERWOOD *et ux.*,  
FREDERICK G. BOYNTON and  
HERBERT C. BROADFOOT, II *et ux.*,  
*Plaintiffs,*

v.

THE UNITED STATES,  
*Defendant.*

---

TRANSCRIPT OF ORAL OPINION  
OF CHIEF JUDGE ALEX KOZINSKI  
ON DECEMBER 21, 1983

THE COURT: So be it. I will just decide the case. Now, I'm not going to have the judgment for you until well into February. In light of what my findings and my tentative conclusions are the sides can do—you know, I'm disappointed in the fact that there has been no settlement, but I have no doubt that much thought has been given, and that without knowing anything about the settlement—and I assure you, Judge Margolis has been very circumspect, has told me nothing at all about the settlement—assuming, because I know counsel from the case and otherwise that it has been in good faith on all sides.

I guess there wouldn't be any call for judges if all the litigants could agree with each other as to how they come out.

Very well. I found this to be,—first of all, I have good news and bad news. It depends on which side. I have given more thought about the part of the case, the American Bar Endowment part of the case, the part that I had decided at the time of the last meeting, and I am pleased to say I haven't changed my mind.

I feel entirely comfortable with the result, and I can tell you now with a fair degree of certainty that that is how it will, in fact, come out in my opinion. I have not started working on the opinion, but once in awhile one makes an oral ruling and is troubled by it, and looks for ways of stepping back or anything of that sort, so I will not be stepping back from what I said the last time we met.

I may be wrong, but I am happily so. I hope I'm right. I do continue in my conclusion that—

MR. RUBLOFF: Your Honor, could I inquire of the Court as to whether any findings of fact, specific findings of fact will be made?

THE COURT: Probably not. You can pick them out of what I said in my opinion. I don't think I will make specific findings. Is there something specific you would like to ask me?

MR. RUBLOFF: Well, I know in other cases it has been the Court's practice to respond to—

THE COURT: To the written questions?

MR. RUBLOFF: To the questions that were specified by the parties as representing the issues in fact.

THE COURT: I looked at this case, and it got so involved and so far from what it was that I actually saw was relevant to the case that I decided not to go down the list of everything. I just didn't think they were all that important. But if you have something that you would like to call my attention to that you think is really im-

portant that I have not resolved, by all means call it to my attention.

I may get a copy of the order and go down with all of you when this is done. I was going to do it, and after four weeks of trial things got so, in my mind, so far afield from some of the things that were in that order specified as issues in dispute that I decided not to do anything with it.

Let me go through and deal with each case, and then we can go back and answer specific questions. Was there anything in particular that you had in mind?

MR. RUBLOFF: No, Your Honor, I didn't mean to make any proposal or request, it was simply an inquiry because I was aware of the fact that in prior cases it had been your practice to respond specifically to the matters contained in, I think it is what you call the order governing—

THE COURT: Proceedings at trial.

MR. RUBLOFF: Right. I just wanted to clarify what the Court's—

THE COURT: Sometimes I do and sometimes I don't, depending on whether I think it is important, depending on whether the parties think [it] is important. I look at it, and I did look at it before the last time I met with you to see whether following down that pathway would prove fruitful, and given the fact that the case was tried by one side geared to DAV to some extent, and somewhat differently by the other side, and since I decided DAV was not really relevant and controlling in this case, because in DAV there was a commercial transaction, you know, the buyers were not related parties, and here there was a difference in that element.

I may go back, let me get a copy of the order and then I may go back and answer some of your questions. Of



course there will always be time in remand to answer some of those questions, too, and there will be remand.

In any case, the question of the four individual Plaintiffs, in a way I found was the most troubling aspect of the case, some of them because the way the case was tried by both sides much of the focus was directed on the Endowment case itself. To some extent there is value in that, because if I understand things correctly, had the Endowment lost that would pretty much have taken care of the individual Plaintiffs. Given that the Endowment has won makes it, I think, a much more difficult case to deal with individual plaintiffs.

And I, you know, had some misgivings, some of which I expressed the last time, about the perception that was conveyed, at least by some of the witnesses, that somehow there was one unitary market for insurance. In fact, it is quite clear there were many markets for insurance, geographically and otherwise. Certainly geographically there were large differences, and I was troubled by the possibility that some—and I still am—that some members of the American Bar Endowment who buy insurance may be getting a terribly good deal, and may get a charitable deduction, when in fact, this is the best deal they could get.

And I was equally troubled that a blanket rule going the other way would perhaps deprive some people who are in fact making a contribution from deduction. But then I thought about it some more and decided it is really my province to decide cases and I will leave policy to people who are paid to set policy, and I can only decide the cases that are before me, and let future cases, future lawyers, future judges, those involved in the administration of justice and the administration of income tax laws and federal regulations deal with questions of equity and equality and what not.

So I went to each individual plaintiff, and I looked to see what there was in the file or what was in the record

that would support his claim for a charitable contribution. And in trying to analyze the evidence I considered the dual payment cases, the cases that talk about making a charitable contribution while paying for something else, and I also considered the authority cited by the United States Government, and the conclusion I came to was that there must be some showing that the payment made had at least in part a charitable component.

That there must be showing that he was not entirely motivated by some other collateral economic concern. If the record did not establish that, the existence of some charitable component, I decided that that plaintiff should not prevail.

In the case of insurance the question was did somebody buy more expensive insurance than he or she, I guess he in this case, could have gotten by—did he buy American Bar Endowment insurance, which was a much worse deal or significantly worse deal than what would have been available elsewhere in the market. And I took each of the plaintiffs in order and looked at the status and what else was in the record, and in the case of Mr. Broadfoot I decided that he did not make such a showing, and I am holding, in his case, in favor of the Defendant.

Mr. Broadfoot, if I did not get my names confused, I believe was one of the gentlemen who lived in Georgia. He had ABE life insurance in the amount of \$50,000, and he said that he was aware at the time he made the application, or the time he paid the check, he was aware of the fact that a portion of this payment would be used, albeit collaterally when it comes back as a dividend, but would be used to support a tax exempt charitable type of activity.

But that is not enough, at least in my reading of the law. Simply knowing that part of a payment goes to a charitable endeavor does not, in my view, render this

payment charitable if in fact the payment was entirely motivated, could have entirely been motivated by other economic concerns.

So it is perfectly consistent for somebody in Mr. Broadfoot's position to have no sympathy at all for the American Bar Endowment, although I am certain that he, in fact, did, or else he wouldn't have been here—it would have been perfectly consistent to know that a portion of the payment were going to those types of activities, and yet paid grudgingly. Pay it, but not be particularly happy about it, or not have that motivation at all, and we had at least one witness who said as much.

He said he was not upset about the fact that the things were going to the ABE, but that was not a motivating factor at all. I found nothing in Mr. Broadfoot's testimony to suggest that the charitable contribution was, in fact, motivating him to buy the insurance from the ABE. It is curious with all these plaintiffs what they did not say, given that they were on the stand and able to testify.

They did not say that they selected this insurance over cheaper available coverage that they had, or equal coverage. Certainly, Mr. Broadfoot did not. He made no indication that he didn't—and not only that, it is enough that he didn't look for the insurance, perhaps because he was so enamoured with the idea of contributing to the ABE. Really, nothing at all that would support the view that he, in fact, bought the ABE insurance at some economic cost to him, at some additional economic cost to him, in order to support American Bar Endowment.

If one looks at the Georgia life plan, and I have said already on this record I find that, Georgia Bar Association plan, and I already said on this record that I find the individual insurance to be materially different from association type of insurance, and I continue to adhere to that view. I believe that individual insurance, because

of the differences in portability, the differences in the ability to get it with or without medical examination, is a different product.

In group insurance, where everybody in the group can get it, it may be limited to in some way geographically, it may be tied to payment of some collateral membership fee, like one has to be a member of the ABA in order to be able to buy the ABE insurance, I find them to be significantly different commodities. So I look at what might have been available to Mr. Broadfoot in Georgia, and the inference is that—well, certainly there was no evidence that he, in fact, considered any other plan, but in fact, the rates were not considerably different between the Georgia plan and the ABE plan, if I remember the figures correctly.

The question of Mr. Broadfoot, as to whether he considered the ABE plan to be outrageously overpriced at the time he bought it, he said he did not, and really, there was no indication at all, certainly not enough of an indication to persuade me that he, in fact, rejected the cheaper available coverage because he felt he wanted to buy the more expensive coverage in order to contribute to the ABE.

So in the case of Mr. Broadfoot I decide in favor—in fact, now that I look I see that Mr. Broadfoot noted that the cost of the Georgia program, in fact, exceeded the cost of the ABE, the Georgia Bar plan exceeded the cost of the ABE coverage. In light of all of that, I simply cannot find that he was making a charitable contribution.

Mr. Turner. Well, let's take Mr. Boynton, who was the other gentleman who was in New York—I'm sorry, in Georgia. Mr. Boynton had a separate issue involving the Ionosphere Club. That issue was resolved in his favor when the Government proceeded and had put no evidence contrary to his testimony in any case, so on that issue Mr. Boynton wins. Mr. Boynton, if my notes



are correct here, was involved in the disability program rather than the life program of the ABE. Again, he noted that he was aware that part of his payment of the premium reflected a payment towards the American Bar Endowment's charitable activities.

There was, however, no indication as to what other coverage might have been available to him. He did say he did look at other available plans. He did not say that those were significantly less expensive, and then he bought American Bar Endowment plan at some additional economic sacrifice to him in order to make a charitable contribution.

As far as this record reflects Mr. Boynton, too, seems to have gotten—at least there is nothing in the record that suggests other than that Mr. Boynton took the best deal he could get on the market. In that case, I found the motivation for purchasing insurance was entirely economic, and that his entire motivation is covered by economic interest, and cannot be deemed, any portion of it can be deemed to be charitable.

Mr. Turner. He is from New York. The interesting point in his testimony is that he says he is not a member of the New York State Bar Association. I must have been under a misapprehension of fact at some point in the proceedings, because I did not recall this, and I had thought that New York like some other states must have an integrated bar, and that being an attorney in New York State would make one automatically a member of the New York State Bar Association. Of course, that is not true in all states, and apparently Mr. Turner's testimony is that that is not true in the State of New York.

I surmise from this that the New York State Bar Association is a voluntary association. It is a voluntary association of which Mr. Turner is not a member, or was not a member at the time he testified, and I don't think he was a member—I can't tell from his testimony,

he says he was formerly a member, it is not clear when, but I gathered from what was said that he was not a member in the tax years in question.

I find Mr. Turner's case just a little bit more difficult because apparently he had had some other insurance, and it is not entirely clear why he switched. It certainly would be consistent to say he might have switched to the ABE plan because he wanted to make a charitable contribution, and he might have switched from a less expensive to a more expensive plan, but he doesn't say that.

He said that he had policies with Provident Mutual and Drexel Life Insurance, it would have been easy for him to say that those plans or establishing those plans were cheaper, and he was doing what would be counter-intuitive moving to a more expensive plan from a cheaper one, or give some other indication that, in fact, he chose ABE other than for the fact it was the best deal in the market. The burden is on the plaintiff. It was not established in the case of Mr. Turner.

I note that he was not a member of the New York State Bar Association, so he could not have taken advantage of the favorable rates available under that plan from New York Life Insurance Company. Those rates, from what the evidence shows, were more favorable, at least for some age brackets. It is not clear to me why Mr. Turner was not a member, what the cost of membership would have been, what other implication there would have been for this membership, so it is certainly impossible to tell whether—on this fact, as to whether whatever cost would have been associated with becoming a member or obtaining membership in the New York State Bar Association, when added to the premium he would have paid for the insurance would, in fact, have made the New York State Bar insurance, where would that be in relation to the ABE.



There is no other evidence on the record that I could see relevant which would suggest other than an entirely economic motive on Mr. Turner's part. Again, the fact that [he] knew that part of his premium was going to these charitable endeavors of the ABE is not sufficient, at least in my view of the law.

The most interesting and difficult case involved Mr. Sherwood, and again I just decided these one case at a time, and I suppose with 50,000 or 75,000 members of the ABE might come trotting in here, I don't know what to say. These are the cases I have before me.

I note, first of all, that he had both life and dependent insurance. As to the dependent insurance, I—again, this is a voluminous record and I did not go hunting through it at great length, but as far as I can tell there was really nothing in the record to show comparison of rates available for the dependent insurance. There was no indication affirmatively from Mr. Sherwood that he bought dependent insurance at great economic, or a greater economic sacrifice to himself in order to benefit the ABE.

So far as the dependent insurance is concerned, I find in favor of Defendant and against the taxpayer.

Now, on the life insurance, what makes this case interesting is that Mr. Sherwood was a member of the New York Bar Association. According to his application for ABE insurance Mr. Sherwood was born in 1939. This is Exhibit No. 353 in the record, and I have no reason to doubt its accuracy. So that means that in 1979 he reached his 40th birthday, in 1980 he would have reached his 41st birthday—in 1980 he would have been 41, in 1981 he would have been 42.

So we have here an individual who was, in fact, eligible for the New York Bar plan, and for whom in the age bracket of 40 to 44, which he would have been in at least for the most part of those three years, the New

York plan would have been somewhat cheaper for the first year, and significantly cheaper for the second or additional years. Apparently the New York plan, there was a high premium in the first year.

So that posed an interesting question, whether the availability of this plan alone, the availability of what I consider to be an equivalent product in the market, in that particular market, would have been a sufficient indication that another product was considered, was rejected, and therefore, the inference ought to be drawn that the taxpayer was choosing a more expensive and less advantageous economic product, and therefore, was doing so for charitable purposes.

That case gave me trouble. It also gave me trouble on—Mr. Sherwood's case also gave me trouble on another count. He had \$320,000 worth of insurance, with \$20,000 of that apparently being with the American Bar Association, and \$320,000 is a fairly odd amount, so there is somewhat of an inference that he bought \$300,000 insurance somewhere, and then maybe \$20,000 from the ABA or the ABE.

Unfortunately, he really don't [sic] say anything of that sort. I looked, and tried to find some indication as to what was going on in his mind when he bought or obtained the insurance. Apparently he bought the insurance in the early '70s and then raised the coverage from \$8,000 to \$20,000 in 1978. He does state that he was aware that a portion of the payment that he made to the Endowment was for, or would go for charitable purposes. But nowhere does he really say that he could have gotten the extra \$20,000 of insurance more cheaply from his insurance company, or indeed, from the New York Bar Association, and that he rejected those in order to make a contribution.

In fact, apparently he was a member of the New York Bar life insurance program, and rejected that, let the

coverage lapse later. It is not explained as to why he did that.

It is a close case in my mind. In order to have Plaintiff prevail, at least in my mind, it would have to be established that, in fact, an equivalent product was available in the market at a significantly lower cost, and I think in this case that was established.

I think it must also be established that the product was known to the taxpayer, and that an affirmative decision was made to reject the lower priced product, and that affirmative decision was based on some desire to make a charitable contribution, and although I find this case close, I decided against the taxpayer and in favor of the Defendant.

There are things that Mr. Sherwood could have said that he did not about his decision to reject or discontinue his coverage under the New York State Bar plan, there were things he could have said as to what the expense would have been of buying an additional \$20,000 of insurance privately, if indeed, that was available, which I assume that it was.

Finally, although I don't think there is anything wrong with this, I think some weight has to be given to the fact that American Bar Endowment insurance was marketed aggressively, and with many indications in the literature that this was a good deal, and a good buy, and I don't mean to suggest that there is anything at all wrong with that.

Given what I have said, the nature of Endowment's endeavor was, and that was that it was a contribution, it was not a business. It was a way for the members to make this economic good available as a group for conducting charitable purposes. I think it was incumbent upon those running the Endowment to try to run it in a way which would maximize, I guess one would call the

revenues, or maximize the benefit to the Endowment from this nice advantage that was provided by the members.

So I think there is nothing wrong at all with advertising that is aggressive, and in some ways suggested this may be the best deal in the market, and indeed, for many people, from the best I can tell, across the country it may very well have been a very good deal, indeed, and perhaps the best deal. It may, in fact, not have been, and I'm not sure that they ever claimed for it to be the best deal in all circumstances, but I think there was enough in the literature where if Mr. Sherwood did not have the two plans side by side, and could not see the exact rates for his particular age group, he might not be aware of the fact that he could have gotten an extra \$10,000 of insurance from the New York Bar Association, perhaps less than he could have with the ABE.

I think it is a leap of faith which is one I'm not going to take without benefit of testimony from the Plaintiff. If Plaintiff wishes to tell me that he has considered a lower cost alternative, rejected it because he wanted to make a contribution, that may very well be a different case. In fact, in my view of the law I would, again depending on the facts of the case, probably rule in favor of the Plaintiff if such a showing were made. But a showing must be made by the Plaintiff and I found in the case of all four Plaintiffs that the showing was simply not made.

Now, I understand why the showing might not have been made. These are test cases, and I suppose a broader victory is always better than a narrow one, a victory where—I am just surmising, just assuming this is what might have happened—that if less is [said] that is fact specific, and these plaintiffs survive that would, of course, be of much greater precedential value one way or the other, in resolving what is a knotty, knotty legal issue and will affect the conduct of the Endowment and the



collection of revenue laws for many years in respect to many people.

I wish I could have come up with a more creative and less fact specific decision in these cases, but from my reading of the law I simply can't. I will not exclude the possibility that under the right set of fact[s] the Plaintiff could show that the purchase of insurance had a charitable component, and in fact, was motivated by more than economic desire to buy insurance. I think the authorities compel that. But on the other hand, I cannot say that once it is established some of those dollars go to charity under any and all circumstances, a portion of the payment was charitable, without assistance from above—just one or two floors above—I don't think I can take either of those positions.

Now, Appellate Courts and Members of Congress and those in the Internal Revenue Service have to look at the broader picture, or may have to look at the broader picture. My responsibility is to decide the cases I have here, and that is where I come down.

So after a truly careful review of the situation of the four plaintiffs, and I have given it considerable thought, I find that the required showing was not made for any of them, except for the one Ionosphere matter which we can put aside, and that I will rule in favor of the Defendant.

Now, do I have my order governing proceedings at trial? Do you have a copy? Is there something in particular you want to ask me? I have copies here you can look at. Someone made some notes, and you know, I don't remember why. I don't think it was me, probably somebody else. I mean, there are little yesses and nos and whatever, it might have been a law clerk. I'm willing to let you look, and don't take whatever is there in terms

of notes as a—I don't know what the notes are, so just ignore them.

As you go through, I will answer any questions that you think are not clear by now, or that—just take your time and go through it, and I will be happy to answer them. I will also use this in writing an opinion, to make sure I cover whatever points I cover or need to be covered.

If you want, I can go through and answer what I can answer. I mean, some of them seem fairly easy, some of them seem complicated and pointless. I don't mind going through and trying to answer.

Maybe we should just go down the list one time and see what we have.

On page 3, Paragraph V, Issues in Dispute.

"The parties agree that the ultimate questions of fact and law in this case are:

a. As to the individual plaintiffs, did they make charitable contributions to the Endowment during the taxable years by virtue of the Endowment's receipt of dividends and experience credits and, if so, in what amount?"

I think I answered that question. It is, as to each individual plaintiff, that they did not.

"b. As to the Endowment, did it have unrelated business taxable income arising from its receipt of dividends and experience credits during the taxable years and, if so, how much?"

I have answered that question as no, it did not have unrelated business income.

Now we get to the difficult questions, okay?

"Subsidiary Questions, A. 1. Did the individual plaintiffs, in making their premium contributions to the Endowment, make 'dual payments' part as a contribution



of dividends and experience credits to the Endowment for charitable uses in the field of law, and part for insurance coverage?"

That is a very difficult question to answer. It is quite clear that the payments that they actually made -were, in fact, partially used to buy insurance, and partially by way of the dividends then used to support the charitable purposes of the Endowment. I'm not sure whether anything more is implied in the question in the concept of dual payments.

Does either side wish to speak to that?

I have said that that does not necessarily apply to a charitable contribution. I do recognize that part of each, and I do find that part of each check paid, at least with these individual plaintiffs, that each check contained—well, that each check was used in part to pay for insurance, and in part eventually through dividends to pay for the Endowment's charitable purposes. Is that satisfactory or clear?

MR. THROWER: May I make a brief comment on that, Your Honor?

THE COURT: Of course, Mr. Thrower.

MR. THROWER: But I haven't seen in your comments or heard in your comments a reflection or comment on our position that the group, by a group decision, has been making a group gift, that it could by a group decision change that in any year, and that where the group participates in the group decision in making a contribution equal to the difference between what they pay and what they could have paid had they made the decision to get the full economic benefit for themselves, that that constitutes the measure of the group gift, and the allocation of it made on an objective basis, and rather than on a subjective basis, would follow what we have done, what the Endowment has done, and what is customarily done under Section 61 and under Section 79.

THE COURT: Well, I accept that theory, and to my mind it brings one so far as to say this is not a business, and therefore, Endowment is not subject to a regular business income tax.

The problem is that by that argument every member of the Endowment makes a contribution, whether they buy insurance or they don't buy insurance. That those who do not buy insurance from the Endowment are nevertheless making the contribution, and that is the economic opportunity of buying—that they forego in having the much cheaper insurance available to them, causing them perhaps to go out and buy—

MR. THROWER: That is certainly true. They make a sacrifice, each member of the American Bar Association, and thereby a member of the Endowment. Each member who does not have the insurance makes the sacrifice. Only the insured members actually pay money which constitutes what we assert is a charitable deduction.

So the sacrifice of the others is essential in order to permit the ongoing program, but it is only the insured members who paid the money, and that entire group of people, whether they are high risk—they might be quite high risk, they might be quite low risk—nevertheless, as a group have the opportunity of getting the insurance at the low cost without any charitable element written into it.

This was the concept that we undertook to reflect, rather than the subjective approach of looking at each member, which I don't think was really advocated by either party, and as we indicate I believe in the earlier filings, it has generally been disapproved both by the Courts and by rulings of the Internal Revenue Service in favor of the objective approach, as is followed under Section 61 and 79, where—

THE COURT: Well, Section 79 is a specific statutory provision, which is a problem—

MR. THROWER: It is specific, simply reflecting this general principle, however.

THE COURT: —that Congress has addressed.

MR. THROWER: That's right.

THE COURT: I am just not able, Mr. Thrower, to —perhaps a case by case approach is not appropriate, and in that case, I simply would rule for the Defendant. I view the question of whether something is a business as something that can be made as a group decision. I don't view the question of whether one makes a charitable contribution as a group decision. That is an individual decision, and the majority of the members of the Endowment cannot make that for the minority.

They can certainly keep them from getting an economic benefit by making a group decision as to what the rates are going to be, but the idea of being forced to make a gift goes contrary to my conception of what a charitable contribution is. I remember Mr.—I don't know why I always forget his name, he was the gentleman with the cane—

MR. WATKINS: Mr. Burnett, Your Honor.

THE COURT: Mr. Burnett, and he paid more for the insurance than he would have paid, but apparently he got the best deal he could, and the fact that he was a member of the group, the majority of which chose to make a charitable contribution, I just don't think that that made him a charitable contributor. He was buying insurance, the best deal he could get, and without—

MR. THROWER: As to Burnett, our position would be that as a member of the group the Burnetts are entitled to participate in this group gift in the same way as others. If they did not participate, then the par-

ticipation of those with an average risk or better than average risk, their participation in the gift would be larger, because the group gift remains the same, but because the group itself could in any year by a group decision reduce the net cost for every member of the group, including the Burnetts, it seemed to us that each member should participate.

Otherwise, if you went to a subjective position on that basis, those in good health and better risk would have a great part of this group gift when you eliminated the Burnetts in the high risk.

THE COURT: Mr. Thrower, I understand your argument, I really do. I simply don't find the model classification. It may be up to the Court of Appeals to come up with—

MR. THROWER: Well, we do appreciate your attention to it.

THE COURT: I understand well enough, and I do find it persuasive in the context of whether this is a business or not. I think that one can as a group make a decision not to operate something as a business, to allow high premiums to be charged voluntarily, and that that does not then render what the revenues, the net revenues as being profit. That far I am willing to go. This concept of a group gift, I just don't think we have a model for it, Mr. Thrower. I think this would be the first case. We would have to resort to something like the Section 79 tables, which is something Congress specifically thought about and legislated, and I like to think of myself as fairly daring and imaginative, but my daring and my imagination has boundaries.

I'm willing to make all of the findings you wish to set up the issues for appeal. I think these are important issues, and obviously they are going to be decided on appeal, and you have my sympathy. I simply have to

follow the law as I see it, and with appropriate limitation of my discretion given that I'm a trial judge and not an appeal judge.

For what it is worth, I recognize that all of the facts you have stated, or all of the things you have presented are, in fact, true. The Endowment could have set the rates lower, it set rates higher—and in fact it is required from an earlier decision—it sets rates higher by a democratic majority process which could have been changed by—I specifically find could have been changed from year to year if there [were] an impetus for it.

I found that there is no reason to believe that the American Bar Association processes are such that they would not be susceptible to democratic change. On the contrary, I would expect they would be, and that, in fact, by consent of the majority, and probably overwhelming majority of the members, this enterprise has been run in a non-business fashion in a way which would be to the general detriment of the group as a whole for the benefit of the association.

Equating that into a group gift for purposes of getting a charitable deduction, I just cannot take it that far.

MR. THROWER: That is where we part, yes. But we understand your position. Thank you, Your Honor, we do appreciate your attention to the case, we know you have given it a lot of thought.

THE COURT: I was going down the list. If there is anything else that needs to be addressed—let's see, item A. 2. on page 4:

"Is the quid pro quo or private financial benefit received by the insured members from their participation payments properly measured by the net cost of the insurance (gross premiums less dividends or experience

credits) plus related expenses or is it measured by the gross premium paid to the insurance companies?"

I never understood that question. Does anybody want me to answer that question? I will try to bisect it for you—I mean, is anybody—Mr. Rubloff?

MR. RUBLOFF: Your Honor, I have the uncomfortable feeling that perhaps I have prodded the Court into responding specifically at this point in time to these questions, when I really didn't intend—

THE COURT: I'm not going to go down and make specific findings of fact, I'll write an opinion, so if there are specific points you want me to hit, you want to be sure that I hit, I think this is the time to ask me. Now, I might cover them in any case, but I might not.

MR. RUBLOFF: Well, Your Honor, my question is that the Court has in the course of its comments on the resolution of the various cases effectively resolved all of the disputed issues of fact, and I find it somewhat troublesome to impose upon the Court now the burden of having to respond to two separate sets of questions posed by the parties, each of which would understandably be posed in such terms as to perhaps favor their respective positions, or to generate an answer to their liking.

So for the Government's part, I am perfectly content if the Court would prefer to defer making any findings at this time and would simply incorporate its findings in its opinion, with the awareness that the parties are interested in the resolution of the subject matter raised by each part[y's] questions.

THE COURT: That's fine with me. I mean, I don't understand all of the questions, and maybe if I get back into it I would just as soon not go through it. So I take it you are equally unhappy with the case by case approach as Mr. Thrower is?



MR. RUBLOFF: Yes, Your Honor. I feel that you have correctly stated the law with respect to the resolution of the individual plaintiffs' cases.

THE COURT: No, my question was, I assume you are equally unhappy about the case by case approach? Mr. Thrower seems to think that that would be unworkable. I think it is unworkable.

MR. RUBLOFF: Well, I don't know if it is appropriate for me to express my personal opinion. I think you have properly stated the law with respect to the individual cases, and I think you have properly applied the law to the facts of those particular cases.

THE COURT: But you understand, Mr. Rubloff, when I come out with the writing I will allow for the possibility that 75,000 members can come in here and make a case that they made a contribution, and if they make that showing, if I'm correct in my ruling, they will win.

MR. RUBLOFF: I understand that, Your Honor.

THE COURT: I don't know how happy you are with that.

MR. RUBLOFF: Well, I don't think I'm unhappy, this is really irrelevant.

THE COURT: It doesn't thrill me.

MR. RUBLOFF: I don't think that my happiness is really relevant. I think my function is to ensure that the law is properly applied, and I do believe that is the case here, and we will just have to take each case as it arises.

THE COURT: Well, I have had three trials since this case finished. I have a two-week trial in January, so don't look for anything before February. I have things to do and places to go, and I do think the case is important and needs to be resolved, and I will write

something because obviously many of the issues, at least some of the issues are—and I will try to do as fair and as clear a statement of what I'm deciding as possible so as to give the Appellate Court an opportunity to reverse it or whatever. I'm not pulling any rabbits out of the hat, I'm trying to be mindful of the position of both parties, and include in my statement of facts as much as I think the parties would want and need in order to make their case on appeal. No doubt the case is going to go on appeal.

I should say though that what I have said here on the record, and what I said the last time on the record, are my findings, and if anything is not included in the opinion it should be—if anything I have stated on the record is not included in the opinion, that should be viewed as a finding of fact, and can be used for purposes of appeal.

Let me now for the last time, and this is, I think, the last time we're going to probably meet before I issue an opinion, let me encourage the possibility of settlement. I know people have tried, you know a little bit more now. I have no idea what went on before. You have a little bit more, pieces of information, and since nothing is going to be forthcoming from me, at least until February, I just cannot do it, it is simply not possible, go back and reflect, factor in additional information and don't be bashful.

There is plenty of room for me to be wrong on both issues. I think this is a difficult case, I think this is an unusual case, and I think it is a case where the outcome on appeal is highly in doubt. So now you know a little bit more.

You know, I am only sorry I was not able to come up with something in the case of the individual plaintiffs that I could live with and that would take care of things in a more blanket fashion. I am not terribly happy

about this way of resolving the case, but I guess I did the best I can, and let people with greater authority to do more.

I would suggest, on the basis of what my comments have been, and on the greatest likelihood that I will not change my mind, and I think it is very clear I will not change my mind, I would like you all to work out a stipulation with the amount of judgment in the Endowment case, because my opinion will require you to file one, because I assume nobody is going to want me to go through the ledgers and figure out the dollars and cents. Yes?

MR. GREGORY: It has been stipulated, Your Honor.

## APPENDIX C

## SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(a) *Allowance of Deduction.*—

(1) *General Rule.*—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year.

\* \* \* \*

(c) *Charitable Contribution Defined.*—For purposes of this section, the term “charitable contribution” means a contribution or gift to or for the use of—

\* \* \* \*

## (2) A corporation . . . —

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes . . . ;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

\* \* \* \*

NOV 26 1985

JOSEPH F. SPANIOL, JR.  
CLERK

(3)  
No. 85-599

**In the Supreme Court of the United States**

OCTOBER TERM, 1985

---

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT

---

UNITED STATES OF AMERICA, PETITIONER

v.

FREDERIC D. TURNER, ET UX., ET AL.

---

ON PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE FEDERAL CIRCUIT

---

REPLY BRIEF FOR THE UNITED STATES

---

CHARLES FRIED  
Solicitor General  
Department of Justice  
Washington, D.C. 20530  
(202) 633-2217



## TABLE OF AUTHORITIES

Cases:	Page
<i>Automobile Club v. Commissioner</i> , 353 U.S. 180.....	10
<i>C.F. Mueller Co. v. Commissioner</i> , 190 F.2d 120.....	7
<i>Carolinas Farm &amp; Power Equipment Dealers v. United States</i> , 699 F.2d 157 .....	1, 2, 9
<i>Dixon v. United States</i> , 381 U.S. 68 .....	10
<i>Louisiana Credit Union League v. United States</i> , 693 F.2d 525 .....	1, 2, 3, 6, 7, 8
<i>Oklahoma Cattlemen's Ass'n v. United States</i> , 310 F. Supp. 320 .....	10
<i>Professional Insurance Agents v. Commissioner</i> , 78 T.C. 246, aff'd, 726 F.2d 1097 .....	1, 2, 4, 5, 7, 8
<i>San Antonio District Dental Society v. United States</i> , 340 F. Supp. 11 .....	10
<i>United States v. American College of Physicians</i> , cert. granted, No. 84-1737 (July 1, 1985) .....	9-10
Statutes and regulation:	
Internal Revenue Code of 1954 (26 U.S.C.) :	
§ 501(c) (3) .....	6
§ 501(c) (6) .....	6
§ 513(c) .....	4, 6, 10
Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 <i>et seq.</i> .....	
Treas. Reg. § 1.513-1 .....	10
Miscellaneous :	
32 Fed. Reg. 17657 (1967) .....	10

**In the Supreme Court of the United States**

OCTOBER TERM, 1985

---

No. 85-599

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT

---

UNITED STATES OF AMERICA, PETITIONER

v.

FREDERIC D. TURNER, ET UX., ET AL.

---

ON PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE FEDERAL CIRCUIT

---

REPLY BRIEF FOR THE UNITED STATES

---

In our petition, we contend that the decision below conflicts with recent decisions of the Fourth, Fifth and Sixth Circuits. See *Carolinas Farm & Power Equipment Dealers v. United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *Professional Insurance Agents v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984). Each of those cases holds that the group insurance activities of a tax-exempt professional association constitute a "trade or business," and that the income derived from such activities is subject to unrelated business income tax. The thrust of respondent's brief (Br. in Opp. 12, 14) is that our contention "ignor[es] the unique facts of this case," facts that assertedly "present a stark contrast" to the facts of the three cases cited above. There is no merit to this assertion.

1. In each of the cases on which we rely, the tax-exempt organization "serve[d] as a middleman between

[its] member[s] \* \* \* and commercial vendors of insurance" (*Louisiana Credit Union League*, 693 F.2d at 528). In its capacity as middleman, each association performed a variety of "promotional and administrative services" (*Professional Insurance Agents*, 726 F.2d at 1100). It selected the insurance underwriter; served as group policyholder; actively supported and officially endorsed the insurance program; distributed informational brochures to its members; answered members' telephone inquiries and otherwise marketed the program; processed its members' application forms and requests for changes in coverage; sent premium notices to its members, collected their premium checks, and forwarded the premiums to the underwriters; and generally "performed the day-to-day administrative tasks essential to the insurance \* \* \* operations." *Louisiana Credit Union League*, 693 F.2d at 533; *Professional Insurance Agents*, 726 F.2d at 1099, 1100, 1102; *Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 168.

In each of the three cases, similarly, the association derived substantial revenues from its insurance activities. These revenues took the form of rebates from the insurance underwriters, computed either as a flat percentage of the members' gross premiums or as experience-rated refunds. *Professional Insurance Agents*, 726 F.2d at 1100-1101; *Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 168; *Louisiana Credit Union League*, 693 F.2d at 528. To the extent that the association retained these payments from the underwriters, rather than distributing those sums to its members, the court of appeals in each case held that "the insurance-related payments received by the [association] must be considered income in its hands." *Id.* at 531. See *Professional Insurance Agents*, 726 F.2d at 1100-1101 & n.1; *Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 168, 171.

In determining whether this insurance-related income was derived from a "trade or business," the court of appeals in each case adopted a "profit motive" test. In *Carolinas Farm & Power Equipment Dealers*, the Fourth Circuit held that "the proper inquiry is whether an

organization conducts an activity to earn a profit. If so, the activity is a trade or business" (699 F.2d at 169). The court observed that the association's insurance operations were "highly profitable," since it "consistently received far more in rebates than it expended in providing insurance services" (*id.* at 170). The court also found "strong evidence of profit motive" in the fact that the association chose to raise money by conducting activities—insurance activities—that were not "substantially related" to its tax-exempt purpose (*id.* at 171). As the Fourth Circuit put it (*ibid.*):

If an activity which is not substantially related to a charitable purpose is conducted in a competitive profit-seeking manner and regularly earns significant profits, a heavy burden must be placed on the organization to prove [that] profit is not its motive. Certainly where, as here, an organization could easily rebate any profits to its members and thus \* \* \* provid[e] them with even lower cost group insurance, that burden must be held unmet.

In *Louisiana Credit Union League*, the Fifth Circuit likewise held that "the 'profit motive' standard is the proper one to be applied," ruling that, "[i]f the organization has as its motive the production of income, the challenged activity constitutes a trade or business under section 513(c)" (693 F.2d at 532). The record in that case indicated that the association had "extensive involvement in insurance \* \* \* activities" and that it engaged in them "primarily because [they] produced revenue necessary to finance [its] operations" (*id.* at 532-533). These facts, the Fifth Circuit explained, showed the existence of a "trade or business" (*id.* at 533):

[The association] did everything short of actually selling the insurance \* \* \* itself: it selected the companies whose products and services would be endorsed, actively marketed and promoted those products and services to [its] member[s] \* \* \*, and performed the day-to-day administrative tasks essential to the insurance \* \* \* operations. More comprehensive involvement would be difficult to imagine. As



reflected by the [association's] receipts for the years in issue, [it] was amply rewarded for its efforts—its activities were highly profitable, and those profits were increasing. We agree with the district court that the [association] had the 'profit motive' for its insurance \* \* \* activities necessary to a finding of a trade or business \* \* \*.

In *Professional Insurance Agents*, the Sixth Circuit explicitly followed these decisions and held that Section 513(c) "requires us to examine the exempt organization's underlying reasons for engaging in the questioned activity. If it has as its motive the production of income, the activity constitutes a trade or business" (726 F.2d at 1102). The court of appeals examined the marketing, administrative, and promotional activities that the association had undertaken to support the insurance program, and concluded that it had "engaged in extensive activity over a substantial period of time with intent to earn a profit" (*ibid.*). The court accordingly held that the association's "motive for offering the insurance policies at issue \* \* \* was one of profit sufficient to support a finding that the premiums it received were from a trade or business" (*ibid.*).

2. In the instant case, the Endowment, like the three associations just discussed, serves as a middleman between its members and commercial vendors of insurance. In that capacity, its full-time staff of 40 performs promotional and administrative services substantially identical to those performed by the employees of those associations. See Pet. 3-4; Pet. App. 2a-3a, 27a; C.A. App. 139, 141-142, 811, 1248-1268. Indeed, respondent does not dispute our contention that its employees discharge during their working day the same types of tasks whose aggregation the Fourth, Fifth, and Sixth Circuits have held to constitute a "trade or business." See Br. in Opp. 12-14.

The Endowment likewise derives substantial revenues from its insurance operations. It causes the underwriters to "set the premiums as high as possible without discouraging participation," charging premiums "at a level competitive with other insurance on the market," so that

the Endowment in turn can "benefit from the high dividends" that result from its members' favorable claims experience (Pet. App. 4a). The Endowment thus contrives, just as the associations in the Fourth, Fifth, and Sixth Circuit cases contrived, to earn large rebates from the insurance underwriters, rebates which it refuses to distribute to its members. Contrary to respondent's contention (Br. in Opp. 4-5, 12-14), it is immaterial who—as between the underwriters and the members—should be regarded as the ultimate "source" of these insurance revenues. A middleman may be paid by the buyer, the seller, or both; in determining whether he is engaged in a "trade or business," it is irrelevant who remunerates him. The point is that the Endowment performed a variety of insurance-related services, the result of which was that it received, through a combination of premium payments from its members and policy dividends from its underwriters, a substantial volume of insurance-related income.

The only question, therefore, is whether the Endowment's insurance-related income was derived from "a trade or business." Three other circuits have held that, in determining whether a tax-exempt organization's insurance activities amount to a trade or business, "the court must look to see whether [it] has engaged in extensive activity over a substantial period of time with intent to earn a profit" (*Professional Insurance Agents*, 726 F.2d at 1102). The court of appeals below did not dispute that the Endowment's insurance operation—which has been conducted since 1955 and involves the administration of billions of dollars in policies held by 57,000 members—amounts to "extensive activity over a substantial period of time." The Federal Circuit, however, refused to find dispositive "the fact that the Endowment \* \* \* set out to make as much 'profit' as possible" (Pet. App. 11a). "Unlike what some other courts may do," the Federal Circuit said, "this court does not find 'profits,' or the maximization of revenue, to be the controlling basis for a determination of whether the unrelated business tax provisions apply" (*ibid.*). In a foot-

note to that sentence, the court explicitly refused to adopt the Fifth Circuit's conflicting legal analysis in *Louisiana Credit Union League*, a case that the Federal Circuit interpreted to stand for the proposition that the "intent to earn a profit [is] determinative." Pet. App. 11a n.4 (citing 693 F.2d at 532).

3. In its brief (Br. in Opp. 15-16), the Endowment accepts our contention (Pet. 14-15) that the cases discussed above cannot be distinguished on the ground principally adduced by the courts below—i.e., that the associations marketing the insurance there were tax-exempt under Section 501(c)(6), whereas the Endowment is tax-exempt under Section 501(c)(3). See Pet. App. 10a, 25a-26a. The Endowment concedes "that a section 501(c)(3) organization and a section 501(c)(6) organization [should not] be treated differently for purposes of section 513 if they are operating in the same manner" (Br. in Opp. 15-16 (emphasis omitted)). The Endowment also appears to agree that its insurance operations entail the performance of substantially the same activities as were performed by those other associations; at least it makes no effort to distinguish the cases on that ground (see Br. in Opp. 12-14). And the Endowment likewise seems to agree that, in running the insurance operation, it was "engaged in extensive activity over a substantial period of time with intent to earn a profit" (*Louisiana Credit Union League*, 693 F.2d at 532).

Respondent nevertheless seeks to distinguish the cases we cite on the basis of what it calls "the unique facts of this case" (Br. in Opp. 12). In respondent's view, it was clear that those other associations were engaged in a "trade or business," since their insurance activities were "carried on for the production of income from the sale of goods or the performance of services" (I.R.C. § 513(c)). According to respondent, however, the Claims Court here made "findings of fact" (Br. in Opp. 9) that the Endowment's revenues were not derived "from the sale of goods or the performance of services" (I.R.C. § 513(c)), but rather "were attributable to the generous decision of Endowment members to support [its] charita-

ble fundraising effort" (Br. in Opp. 9). The Claims Court assertedly based this finding of fact on subsidiary findings that the Endowment's insurance program was devised "as a means for charitable fundraising" (Br. in Opp. 4), that its members "considered the insurance program a fundraising activity" (*id.* at 7 n.7), that the insurance revenues reflected "the 'intent of the members to support [its] charitable activities'" (*id.* at 11), and that its members knew that part of their premiums "would go to charity" (*id.* at 8).

Contrary to respondent's contention, the Claims Court was not "finding facts" when it characterized the Endowment's insurance activities as "charitable fundraising." Rather, it was engaging in a labeling process that is not responsive to the question presented. In determining whether the Endowment's insurance activities constitute a "trade or business," it is legally irrelevant that it describes those activities as "charitable fundraising," since *all* of a charity's money-raising activities can be so described. One could well have styled NYU's sale of spaghetti through its macaroni factory as "charitable fundraising," since the profits went to finance NYU's educational activities. See *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951). Indeed, the Fifth and Sixth Circuits have observed that the insurance operations of a tax-exempt organization "are basically a fund raising activity," but have held that those activities are nevertheless an unrelated "trade or business." *Professional Insurance Agents*, 726 F.2d at 1104; *Louisiana Credit Union League*, 693 F.2d at 537. It is likewise irrelevant that the Endowment's members wanted to aid its charitable endeavors and knew that part of their premiums would "go to charity." People who purchased spaghetti from NYU's macaroni company rather than from its competitors may well have known that part of the purchase price would "go to charity," and may well have been motivated by the thought that NYU would make good use of the profits thus derived. But Congress dictated the irrelevance of these facts by enacting the unrelated business income tax in 1950, and



by amending it in 1969 to make clear that "the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services" (I.R.C. § 513(c)).

Equally irrelevant in determining whether respondent was engaged in a "trade or business" are the facts that the Endowment "set premiums at levels significantly higher than necessary" to cover its costs (Br. in Opp. 6), and that its "receipts have far exceeded the value of any services which might have performed in the course of its administration of the plan" (Pet. App. 9a). To begin with, respondent's most valuable services were not the mechanical tasks of administering the plan, but its ability to exploit its unique access to a pool of better-than-average insurance risks by endorsing, marketing, and promoting the program. The group insurance plans involved in the Fourth, Fifth, and Sixth Circuit cases for similar reasons were also "highly profitable" (e.g., *Louisiana Credit Union League*, 693 F.2d at 533). The association in *Professional Insurance Agents*, for example, incurred expenses of only \$12,000 to generate income of \$176,000 from its insurance plans. Noting the wide differential between the one figure and the other, the Tax Court reasoned that the association "was being compensated not so much for the administrative services it performed as it was for endorsing the insurance company's product and providing a direct pipeline to its membership." 78 T.C. 246, 262 (1982).

More fundamentally, respondent's approach confuses the perspective of the seller with that of the retail buyer. Middlemen invariably mark up the goods or services they sell; that is how they make money. The principal constraint on a middleman's ability to make profits is the market; if he seeks too high a mark-up above his costs, customers will buy elsewhere. The only relevant factual question, therefore, was whether the retail price that the Endowment charged for participation in its group insurance plan was within the range of prices for comparable insurance in the retail marketplace generally. A trial was held to answer this question, and the Claims

Court found that the Endowment's "gross premiums were set with reference to the rates for other insurance products available in the market" (Pet. App. 29a). The Federal Circuit affirmed that finding, noting that the Endowment "set the premium at a level competitive with other insurance on the market" (*id.* at 4a). These factual findings, which are really the only important factual findings in the case, mean that the retail price paid by the Endowment's members was equal to the fair market value of the insurance they purchased, so that they have no claim to any charitable contribution deduction. These factual findings also show that the Endowment's insurance operation was "conducted in a competitive profit-seeking manner" (*Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 171), and thus constitutes a "trade or business" under the "profit motive" test adopted by the Fourth, Fifth, and Sixth Circuits.

4. The Endowment asserts (Br. in Opp. 17), as did the Claims Court (Pet. App. 46a), that "for 21 years the Internal Revenue Service took the position that ABE's operation of the insurance program was not taxable." This assertion is incorrect. The Endowment's insurance operation, begun in 1955, first came under audit in the late 1960s. In 1972, during one of these audits, the IRS National Office issued technical advice to the Chicago District Director in which it determined that the unrelated business income tax should not be asserted against the Endowment's insurance profits for its 1965-1967 tax years. In 1973, the National Office revised and reissued this unpublished technical advice memorandum to make the rationale more restrictive. Upon further reflection, the IRS in 1976 withdrew its favorable ruling altogether and advised the Endowment no longer to rely on it (C.A. 854).

This course of administrative action adds nothing to the Endowment's case. The short-lived favorable rulings of 1972 and 1973 related to tax years (1965-1967) that preceded the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 *et seq.* As explained in greater detail in our brief in *United States v. American College of*



*Physicians* (84-1737 U.S. Br. at 22-26), the 1969 Act included the first statutory definition of the phrase "trade or business" for purposes of the unrelated business income tax; that definition is now codified in Section 513(c). In determining not to assert the tax against the Endowment for pre-1969 tax years, the IRS was cognizant of two court decisions (*Oklahoma Cattlemen's Ass'n v. United States*, 310 F. Supp. 320 (W.D. Okla. 1969); *San Antonio District Dental Society v. United States*, 340 F. Supp. 11 (W.D. Tex. 1972)), likewise involving pre-1969 tax years, which had characterized the definition of "trade or business" as a "problem" and noted that the Code prior to 1969 provided no helpful guidance. Moreover, the definition of "trade or business" set forth in the Treasury Regulations, which the 1969 Act codified, did not appear until after the close of the Endowment's 1967 tax year. See Treas. Reg. § 1.513-1; 32 Fed. Reg. 17657 (1967). The Commissioner's determination not to assert the unrelated business income tax against the Endowment for its 1965-1967 tax years thus has little if any bearing on whether the tax applies under Section 513(c) as it now stands. At all events, this Court has regularly held that the Commissioner is free to change his legal position if he determines that his initial conclusion was in error. *Automobile Club v. Commissioner*, 353 U.S. 180 (1957); *Dixon v. United States*, 381 U.S. 68 (1965).

For these reasons and the reasons set forth in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FRIED  
Solicitor General

NOVEMBER 1985

FEB 14 1986

JOSEPH F. SPANIOLO, JR.  
CLERK

No. 85-599

4

# In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT

UNITED STATES OF AMERICA, PETITIONER

v.

FREDERIC D. TURNER, ET UX., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT  
OF APPEALS FOR THE FEDERAL CIRCUIT

## JOINT APPENDIX

FRANCES M. GREGORY, JR.  
*Sutherland, Asbill & Brennan*  
*1666 K Street, N.W.*  
*Suite 800*  
*Washington, D.C. 20006*  
*(202) 872-7800*  
*Counsel for Respondents*

CHARLES FRIED  
*Solicitor General*  
*Department of Justice*  
*Washington, D.C. 20530*  
*(202) 633-2217*  
*Counsel for Petitioner*

PETITION FOR WRIT OF CERTIORARI  
FILED OCTOBER 7, 1985  
CERTIORARI GRANTED DECEMBER 2, 1985

Volume I

244 pp

## TABLE OF CONTENTS\*

	Page
1. Claims Court docket entries .....	1
2. Court of appeals docket entries .....	17
3. Complaint, Cl. Ct. No. 465-82T .....	21
4. Answer .....	33
5. First amended answer .....	37
6. First amended complaint .....	41
7. Answer to first amended complaint .....	45
8. Complaint, Cl. Ct. No. 163-83T .....	47
9. Answer .....	53
10. Excerpts from transcript of proceedings, May 12, 1983, before the Claims Court .....	56
11. Joint memoranda re stipulations .....	71
12. Excerpts from transcripts of proceedings, October 11 through November 11, 1983, before the Claims Court ..	112
13. IRS General Counsel Memorandum (G.C.M.) 36713 ..	541
14. Order allowing certiorari .....	543

---

\* The opinion and judgment of the court of appeals, and the opinion and judgment of the Claims Court, are printed in the appendix to the petition for writ of certiorari and have not been reproduced here.



**In the United States Claims Court**

---

No. 465-82T

---

AMERICAN BAR ENDOWMENT, PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

---

**RELEVANT DOCKET ENTRIES**

---

DATE	PROCEEDINGS
Sep 16 1982	Filing fee of \$10 paid by plaintiff.
Nov 15 1982	Defendant's motion for enlargement of time (to JAN 14 1982) to respond to the complaint filed. Service by mail: NOV 15 1982 ALLOWED: NOV 16 1982.
Dec 28 1982	See Case No. 366-79 C for Order assigning case to Chief Judge Alex Kozinski. Copy to parties.
Jan 3 1983	Order entered governing proceedings before trial. Copy to parties.
Jan 12 1983	Defendant's motion for enlargement of time (to JAN 28 1983) to file its answer filed. Service by mail: JAN 12 1983. ALLOWED: JAN 17 1983 endorsement on motion.
Jan 17 1983	Notice to counsel filed. Copy to parties.
Jan 17 1983	Amended Order governing proceedings before trial filed. Copy to parties.
Jan 25 1983	Defendant's motion for enlargement of time (to FEB 11 1983) to file its answer to the complaint filed. Service by mail: JAN 25 1983. DENIED as moot: MAR 2 1983.

Feb 7 1983 Notice to counsel and order filed. [plaintiff's memorandum: 21 days; defendant's response: 14 days thereafter] Copy to parties.

Feb 11 1983 Defendant's answer filed. Service by mail: FEB 11 1983.

Feb 17 1983 Defendant's motion for summary judgment, supporting brief, and appendix B (two separate documents filed. Service: FEB 17 1983. Pleadings rejected for failure to comply with order of January 17, 1983: FEB 22 1983.

Feb 23 1983 Defendant's motion for summary judgment filed. Service: 2/23/83. WITHDRAWN. SEE ORDER ENTERED MAY 13 1983.

Feb 23 1983 Appendix B to defendant's brief (in one bound volume) filed. Service: 2/17/83.

Feb 25 1983 Plaintiff's memorandum in response to the court's order of February 7, 1983 filed. Service: 2/25/83.

Mar 4 1983 Defendant's motion for leave to amend the answer filed. Service: MAR 4 1983. ALLOWED as unopposed: MAR 10 1983.

Mar 8 1983 Plaintiff's response to defendant's motion for leave to amend answer filed. Service by mail: 3/8/83.

Mar 10 1983 Defendant's first amended answer filed. Service: 3/4/83.

Mar 11 1983 Defendant's motion for extension of time (to March 18, 1983) to file its memorandum in response to the Court's order of February 7, 1983 filed. Service by mail: 3/11/83. ALLOWED: MAR 14 1983.

Mar 14 1983 Plaintiff's response to defendant's motion for enlargement of time filed. Service by mail: 3/14/83.

Mar 18 1983 Defendant's memorandum in response to Court's order of February 7, 1983 filed. Service: 3/18/83.

Mar 22 1983 Plaintiff's opposition to defendant's motion for summary judgment filed. Service: 3/22/83.

Mar 28 1983 Plaintiff's motion for leave to file defendant's answers to plaintiff's first set of interrogatories filed. Service: 3/28/83. ALLOWED: APR 8 1983; see Judge's order filed this date.

Mar 30 1983 Plaintiff's reply to defendant's memorandum in response to Court's order of February 7, 1983 filed [by leave of the Judge]. Service: 3/28/83.

Mar 31 1983 Judge's order scheduling oral argument filed. Copy to parties.

Apr 5 1983 Defendant's motion for extension of time (to April 12, 1983) to file its reply brief filed. Service by mail: 4/5/83. ALLOWED as unopposed: APR 6 1983.

Apr 8 1983 Plaintiff's motion for leave to file defendant's supplemental response to plaintiff's first set of interrogatories filed. Service by mail: 4/7/83. ALLOWED: APR 8 1983; see Judge's order filed this date.

Apr 8 1983 Judge's order filed. Copy to parties.

Apr 8 1983 Plaintiff's first set of interrogatories to defendant filed. Service: 3/22/83.

Apr 8 1983 Defendant's supplemental response to plaintiff's first set of interrogatories filed. Service by mail: 4/1/83.

Apr 12 1983 Defendant's reply brief in support of motion for summary judgment filed. Service by mail: APR 12 1983.

Apr 12 1983 Defendant's motion for leave to file response to statement of "genuine issues" filed. Service by mail: APR 12 1983. ALLOWED: APR 14 1983.

Apr 14 1983 Defendant's response to plaintiff's statement of "genuine issues" filed. Service by mail: APR 12 1983.

Apr 27 1983 Transcript of proceedings (1 volume) taken at Washington, D.C. on April 7, 1983 filed. Notice to parties.

May 6 1983 Notice to counsel filed by Chief Judge. Copy to parties.

May 13 1983 Order allowing defendant's motion to withdraw its motion for summary judgment [made orally in hearing], setting case for trial, and affording counsel to May 23, 1983 to invoke optional procedures for complex cases, etc. filed. Copy to parties.

May 26 1983 Plaintiff's motion for protective order filed. Service by mail: 5/26/83. ALLOWED. SEE ORDER ENTERED JUN 13 1983.

May 31 1983 See 320-83 T for motion to consolidate. ALLOWED: JUN 1 1983.

May 31 1983 See 351-83 T for motion to consolidate. ALLOWED: JUN 1 1983.

Jun 3 1983 Order governing proceedings before trial filed in 351-83T. Copy to parties.

Jun 6 1983 Transcript of proceedings (1 volume) taken at Washington, D.C. on May 12, 1983 filed. Notice to parties.

Jun 7 1983 Defendant's response to plaintiff's motion for protective order filed. Service by mail: 6/6/83.

Jun 13 1983 Order re: status hearing, allowance of motion for protective order, and pretrial conference filed. Copy to parties.

Jun 14 1983 Protective order filed by the Chief Judge. Copy to parties.

Jul 5 1983 Transcript of proceedings (1 volume) taken at Washington, D.C. on June 8, 1983 filed. Notice to parties.

Jul 8 1983 Judge's order amending order governing proceedings, etc. filed. Copy to parties. [No discovery to be taken after September 17, 1983.

Jul 15 1983 Plaintiff's motion for leave to amend its complaint filed. Service: 7/15/83. ALLOWED: JUL 18 1983.

Jul 18 1983 Defendant's motion to compel production of documents filed. Service: 7/15/83. Resolved at hearing held on July 28, 1983. SEE ORDER ENTERED JUL 29 1983.

Jul 18 1983 Defendant's answer filed in 320-83T. Service: 7/18/83.

Jul 18 1983 Plaintiff's first amendment to the complaint filed. Service: 7/15/83.

Jul 21 1983 Order of the Chief Judge in re deposition of Russell Siders filed. Copy to parties.

Jul 25 1983 Defendant's motion for an order permitting depositions of experts or, alternatively, for an order relating to the scope of certain depositions filed. Service: 7/22/83. Resolved at hearing held on July 28, 1983. SEE ORDER ENTERED JUL 29 1983.



Jul 28 1983 Defendant's answer to first amendment to complaint filed. Service by mail: 7/28/83.

Jul 29 1983 Judge's order re hearing held on July 28, 1983, and cancelling hearing for August 4, 1983 filed. Copy to parties.

Aug 1 1983 Defendant's answer filed in 351-83 T. Service by mail: 8/1/83.

Aug 2 1983 Transcript of proceedings (1 volume) taken at Washington, D.C. on July 5, 1983 filed. Notice to parties.

Aug 8 1983 Transcript of proceedings (1 volume) taken at Washington, D.C. on July 21, 1983 filed. Notice to parties.

Aug 9 1983 Transcript of proceedings (1 volume) taken at Washington, D.C. on July 28, 1983 filed. Notice to parties.

Aug 10 1983 Joint motion of OMAHA FINANCIAL LIFE INSURANCE COMPANY and UNITED OF OMAHA LIFE INSURANCE CO. to quash subpoenas for deposition and production of documents and for protective order filed [by leave of the Judge]. Service by mail: 8/9/83. DENIED: SEE ORDER OF AUGUST 15, 1983.

Aug 15 1983 Chief Judge's order denying the joint motion of Omaha Financial Life Insurance Company and United of Omaha Life Insurance Company to quash subpoenas for deposition and production of documents and for protective order filed. Copy to parties and United of Omaha Insurance Co. and Omaha Financial Life Insurance Co.

Aug 26 1983 Transcript of proceedings (1 volume) taken at Washington, D.C., on August 11, 1983, filed. Notice to parties.

Aug 29 1983 Defendant's motion for a protective order filed. Service: 8/26/83.

Aug 29 1983 Defendant's motion to compel filed. Service: 8/29/83. [contains IN CAMERA information]

Sep 9 1983 Plaintiff's opposition to defendant's motion for protective order filed. Service: 9/9/83.

Sep 12 1983 Objection of Edward E. Murphy, Jr. to subpoena duces tecum dated September 6, 1983 filed [by leave of the Judge]. Service by mail: 9/9/83.

Sep 12 1983 Plaintiff's opposition to defendant's motion to compel filed. Service: 9/12/83.

Sep 13 1983 Defendant's second motion for an order permitting deposition and other discovery of experts filed. Service: 9/13/83. SEE ORDER ENTERED SEP 21 1983.

Sep 15 1983 Plaintiff's opposition to defendant's second motion for an order permitting deposition and other discovery of experts filed. Service: 9/15/83.

Sep 19 1983 Motion fo [sic] BENEFICIAL STANDARD LIFE INSURANCE COMPANY for protective order filed. Service: 9/19/83. SEE ORDER ENTERED OCT 17 1983.

Sep 21 1983 Response to plaintiff to objection of Edward E. Murphy, Jr. to subpoena duces tecum dated September 6, 1983 filed [by leave of the Judge]. Service by mail: 9/21/83 (re: Murphy); service: 9/21/83.

- Sep 21 1983 Order of the Chief Judge allowing each party to depose the expert witnesses of the opposing party, etc., and except as provided re: depositions, directing that no further motions regarding discovery will be entertained by the court, filed. Copy to parties.
- Sep 28 1983 Motion for protective order filed by Continental American Life Insurance Company, Fireman's Fund Insurance Company, National Home Life Assurance Company of New York, National Home Life Assurance Company, and Life Insurance Company of North America. Service: 9/28/83. SEE ORDER ENTERED OCT 17 1983.
- Oct 3 1983 Transcript of proceedings (1 volume) taken at Washington, D.C. on September 16, 1983 filed. Notice to parties.
- Oct 3 1983 Plaintiff's response to motion for protective order (filed 9/28/83) filed. Service: 10/3/83.
- Oct 4 1983 Plaintiff's motion for extension of time (to October 5, 1983) to file memorandum re stipulations filed. Service: 10/4/83. ALLOWED: OCT 4 1983.
- Oct 4 1983 Plaintiff's motion for a protective order for use at trial filed. Service: 10/4/83. SEE ORDER ENTERED OCT 17 1983.
- Oct 4 1983 Plaintiff's memorandum of contentions of fact and law, etc. filed. Service: 10/4/83.
- Oct 4 1983 Plaintiff's exhibit list filed. Service: 10/4/83.
- Oct 4 1983 Plaintiff's witness list filed. Service: 10/4/83.

- Oct 5 1983 Defendant's witness list, defendant's exhibit list, and defendant's memorandum of contentions of fact and law (in two volumes) totaling four separate items, filed [by leave of the Judge], and placed IN CAMERA. Service by mail in re: all items: 10/4/83.
- Oct 5 1983 Defendant's motion for extension of time (to October 6, 1983) to file memorandum re stipulations pursuant to amended order governing proceedings, etc. filed. Service: 10/5/83. GRANTED: OCT 6 1983.
- Oct 6 1983 Defendant's motion to substitute modified contentions of law and fact with attached memorandum of contentions of law and fact filed, and placed IN CAMERA. GRANTED: OCT 6 1983.
- Oct 6 1983 Joint memorandum re stipulations submitted pursuant to AOGPBT ¶VI filed.
- Oct 6 1983 Joint memorandum re stipulations submitted pursuant to AOGPBT ¶VI filed in 163-83T.
- Oct 6 1983 Joint memorandum re stipulations submitted pursuant to AOGPBT ¶VI filed in 190-83T.
- Oct 6 1983 Joint memorandum re stipulations submitted pursuant to AOGPBT ¶VI filed in 320-83T.
- Oct 6 1983 Joint memorandum re stipulations submitted pursuant to AOGPBT ¶VI filed in 351-83T.
- Oct 7 1983 Plaintiff's motion to strike portions of defendant's witness list filed. Service: 10/7/83. OCT 17 1983: ALLOWED as to individual insured only.

Oct 7 1983 Plaintiff's motion to strike defendant's exhibit list filed. Service: 10/7/83.

Oct 7 1983 Defendant's motion for leave to file attachments to stipulation out of time filed. Service: 10/7/83. ALLOWED: OCT 11 1983.

Oct 11 1983 Supplemental joint memorandum re stipulations, together with Exhibits 1337, 1338, 1339, 1340, 1341, 398, 2, 187, and 188 filed by plaintiff [by leave of the Judge]. Service: 10/7/83. [Note: Defendant's Exhibit 1338 "protected" and placed IN CAMERA.]

Oct 17 1983 Order governing proceedings at trial filed. Service made by Judge.

Oct 17 1983 Protective order for use at trial filed. Service made by Judge.

Oct 19 1983 Order of the Chief Judge allowing defendant to issue subpoenas requiring attendance at trial to individuals listed on its witness list filed. Copy to parties.

Oct 25 1983 Second supplemental joint memorandum re stipulations filed.

Oct 28 1983 Motion of Continental American Life Insurance Company, Fireman's Fund Insurance Company, Fireman's Fund Life Insurance Company, National Home Life Assurance Company of New York, National Home Life Assurance Company, and Life Insurance Company of North America to vacate order, or in the alternative, to quash subpoenas filed [by leave of the judge]. Service by mail: 10/26/83. MOOT: NOV 1 1983.

Nov 4 1983 Plaintiff's memorandum of law filed [by leave of the judge]. Service: 11/4/83.

Nov 15 1983 Order of the Chief Judge scheduling status hearing filed. Copy to parties.

Dec 23 1983 Transcript and exhibits filed. Notice to parties. [See complete listing attached to page 6].

Jan 19 1984 Transcript of proceedings [1 volume] taken at Washington, D.C. on December 21, 1983 filed. Notice to parties.

Jan 31 1984 Chief Judge's opinion directing parties to file a stipulation setting forth the amount of plaintiffs' judgment in Nos. 465-82T and 320-83T by 12:30 p.m. on February 2, 1984, and directing the clerk to enter judgment in those cases and dismissing the complaints in 163-83T, 190-83T, and 351-83T, with costs to the prevailing party in each case filed [in this, 163-83T, 190-83T, 320-83T, and 351-83T]. Copies to parties.

Feb 2 1984 Stipulation re judgment amounts filed by deft. Service: 2/2/84.

Feb 2 1984 Judgment entered for plaintiff in case No. 465-82T in the amount of \$6,912,074.85 in unrelated business income tax and assessed interest previously collected, plus statutory interest; for the plaintiff in 320-83T in the sum of \$19.00 plus statutory interest; and dismissing the complaints in case Nos. 163-83T, 190-83T, and 351-83T, pursuant to the opinion of Jan 31 1984 and the stipulation re judgment amounts filed on Feb 2 1984. Copy to parties.



- Feb 2 1984- Certified transcript of judgment forwarded to attorney of record [in this, 163-83T, 190-83T, 320-83T and 351-83T]. See correspondence in file.
- Feb 10 1984 Plaintiff's motion that certain pages of the transcript and certain exhibits be marked "Protected Information" and filed under seal, filed. Service: 2/10/84. ALLOWED: FEB 15 1984.
- Feb 21 1984 Joint preliminary status report filed *nunc pro tunc* 6/8/83.
- Mar 9 1984 Plaintiff's motion to correct transcript filed. Service: 3/9/84. WITHDRAWN; SEE ORDER ENTERED APR 5 1984.
- Mar 19 1984 Defendant's response to plaintiff's motion to correct transcript filed. Service by mail: 3/19/84. WITHDRAWN; SEE ORDER ENTERED APR 5 1984.
- Mar 30 1984 Notice of appeal filed by defendant. Copy to plaintiff and C.A.F.C.
- Apr 2 1984 Notice of appeal filed by plaintiffs in cases 163-83T, 190-83T, 320-83T, and 351-83T. Copy to defendant and C.A.F.C. [\$70.00 fee paid.]
- Apr 4 1984 Stipulation re correction of transcript filed by the parties.
- Apr 5 1984 Order of the Chief Judge approving the stipulation re correction of the transcript, etc. filed. Copy to parties.

## In the United States Claims Court

No. 163-83T

FREDERICK D. TURNER AND  
MARGARET S. TURNER, PLAINTIFFS

v.

THE UNITED STATES, DEFENDANT

### RELEVANT DOCKET ENTRIES

DATE	PROCEEDINGS
Mar 21 1983	Filing fee of \$60 paid by plaintiffs.
Mar 21 1983	Notice of assignment to Chief Judge Alex Kozinski filed. Copy to parties.
Mar 21 1983	Plaintiff's notice of related case [465-82T] filed.
Apr 11 1983	Order governing proceedings before trial filed. Copy to parties.
May 16 1983	Plaintiffs' motion to consolidate with case no. 465-82T filed. Service: 5/16/83. ALLOWED: MAY 31 1983.
May 20 1983	Defendant's answer filed. Service by mail: MAY 20 1983.
May 25 1983	Defendant's response to plaintiffs' motion to consolidate filed. Service by mail: 5/25/83.
May 26 1983	Plaintiffs' reply memorandum in support of motion to consolidate filed. Service: 5/26/83.
May 31 1983	SEE CASE NO. 465-82T FOR FURTHER PROCEEDINGS.

# In the United States Claims Court

---

No. 190-83T

---

ARTHUR M. SHERWOOD AND  
KAREN H. SHERWOOD, PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

---

## RELEVANT DOCKET ENTRIES

---

DATE	PROCEEDINGS
Mar 29 1983	Filing fee of \$60 paid by plaintiffs.
Mar 29 1983	Plaintiffs' notice of related case [465-82T and 163-83T] filed.
Mar 29 1983	Notice of assignment to Chief Judge Alex Kozinski filed. Copy to parties.
Apr 11 1983	Order governing proceedings before trial filed. Copy to parties.
May 16 1983	Plaintiffs' motion to consolidate with case no. 465-82T filed. Service: 5/16/83. ALLOWED: MAY 31 1983.
May 25 1983	Defendant's answer filed. Service: 5/25/83.
May 25 1983	Defendant's response to plaintiffs' motion to consolidate filed. Service by mail: 5/25/83.
May 26 1983	Plaintiffs' reply memorandum in support of motion to consolidate filed. Service: 5/26/83.
May 31 1983	SEE CASE NO. 465-82T FOR FURTHER PROCEEDINGS.

# In the United States Claims Court

---

No. 320-83T

---

FREDERICK G. BOYNTON, PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

---

## RELEVANT DOCKET ENTRIES

---

DATE	PROCEEDINGS
May 18 1983	Filing fee of \$60 paid by plaintiff.
May 18 1983	Notice of assignment to Chief Judge Alex Kozinski filed. Copy to parties.
May 18 1983	Plaintiff's notice of related case [465-82T] filed.
May 24 1983	Order governing proceedings before trial filed. Copy to parties.
May 31 1983	Plaintiff's motion to consolidate this with Case No. 465-82T filed. Service: 5/31/83. ALLOWED: JUN 1 1983.
Jun 1 1983	See 465-82T for further proceedings.

# In the United States Claims Court

No. 351-83T

HERBERT C. BROADFOOT, II AND  
NANCY L. BROADFOOT, PLAINTIFFS

v.

THE UNITED STATES, DEFENDANT

## RELEVANT DOCKET ENTRIES

DATE	PROCEEDINGS
May 31 1983	Filing fee of \$60 paid by plaintiffs.
May 31 1983	Plaintiffs' notice of related case filed.
May 31 1983	Notice of assignment to Chief Judge Alex Kozinski filed. Copy to parties.
May 31 1983	Plaintiffs' motion to consolidate this with Case No. 465-82T filed. Service: 5/31/83. ALLOWED: JUN 1 1983.
Jun 1 1983	See 465-82T for further proceedings.

# United States Court of Appeals for the Federal Circuit

No. 84-988

AMERICAN BAR ENDOWMENT, PLAINTIFF-APPELLEE

v.

THE UNITED STATES, DEFENDANT-APPELLANT

## RELEVANT DOCKET ENTRIES

DATE	PROCEEDINGS
	* * * * *
April 10, 1985	7. Appellant's citation of add'l authority, received. (Circulated to panel 4/15/85) (ejc)
April 15, 1985	8. Appellee's response to appellant's citation of additional authority, rec'd. & circulated to the panel. (scg)
May 10, 1985	Affirmed in part, reversed and remanded in part. Davis, J. (84-988 is affirmed; 84-1000 is reversed & remanded.)
May 23, 1985	9. Appellant's Bill of Costs, filed. (rs) ALLOWED: 6/6/85 for \$1842.95
June 6, 1985	MANDATE ISSUED TO THE MSPB. (rs)
	FUTURE ENTRIES WILL REFER TO THE PARTY DESIGNATION & PAPERS IN 84-1000
July 15, 1985	10. Appellee's motion to recall mandate or stay proceedings, filed (SD-7/15-H). (bam) STAY GRANTED: 7/17/85 to & until August 9, 1985; If Solicitor Gen.



has determined by that date to seek a petition for certiorari, the stay will continue until the filing & disposition of the petition; if the Solicitor Gen. has not so determined by that time, the stay will expire on that date unless further extended by Claims Court or this Court. (This action is only filed in 84-1000 Turner v. U.S.).(bam)

- July 19, 1985 11. Appellants' request for reconsideration of the motion of the U.S. in 84-1000 to recall mandate or stay proceedings below, filed. (SD-7/19-H) (ejc)
- July 24, 1985 Called Bob Pomerance Re: response to request for reconsideration of the motion of the U.S. in 84-1000 to recall mandate or stay proceedings below. DOJ was not served a copy of request. Sent copy 7/24. DOJ will call to inform court whether or not a response to the request will be filed. Call #28 when DOJ calls. (amm)
- July 29, 1985 12. United States' opposition to motion for reconsideration of stay of proceedings below for Appeal No. 84-1000, filed. (SD-7/26-M) (ejc)
- July 30, 1985 13. Court has affirmed the original stay of the Court entered on July 17, 1985, for appeal No. 84-1000. (bam)
- July 31, 1985 CHIEF JUSTICE SIGNED AN ORDER EXTENDING THE TIME TO FILE A PETITION FOR WRIT OF CERTIORARI TO & INCLUDING October 7, 1985.(bam)

- August 14. Letter from appellant in re the filing of petition for writ of certiorari to the Supreme Court, received. (ejc) (for Appeal 84-1000)
- Oct. 7, 1985 PETITION FOR CERTIORARI FILED IN APPEAL # 85-599, IN THE SUPREME COURT. (scg) (GRANTED: Dec. 2, 1985.) scg

**United States Court of Appeals  
for the Federal Circuit**

No. 84-1000

FREDERIC D. TURNER, ET UX.,  
ARTHUR SHERWOOD, ET UX, ET AL., APPELLANTS

v.

THE UNITED STATES, APPELLEE

**RELEVANT DOCKET ENTRIES**

DATE	PROCEEDINGS
April 9, 1984	1. Certificate of interest filed by appellant. (bam)
April 11, 1984	2. Joint motion to consolidate this with Appeal No. 84-988 (with proposed briefing schedule and request to file deferred appendix under Rule 30(c) filed. (ejc) GRANTED: 4/12/84. (bam)

CONSOLIDATED  
SEE 84-988 FOR FUTHER  
ENTRIES.

Oct. 7, 1985	PETITION FOR CERTIORARI FILED IN THE SUPREME COURT; APPEAL NO. 85-599. (scg) (GRANTED: DEC. 2, 1985) scg
--------------	--

**In the United States Court of Claims**

Docket No. 465-82T

AMERICAN BAR ENDOWMENT, PLAINTIFF,

v.

UNITED STATES OF AMERICA, DEFENDANT.

**PETITION**

(Filed: September 16, 1982)

*To the Honorable Judges of the United States Court of  
Claims:*

Plaintiff, the American Bar Endowment ("the Endowment"), brings this action and respectfully alleges to this Honorable Court and says:

**I**

*Jurisdiction*

**1.**

This is an action arising under the internal revenue laws of the United States and is brought pursuant to section 1491 of Title 28 of the United States Code as amended.

**II.**

*Refund Claimed*

**2.**

This action is brought for the recovery of the following amounts of unrelated business income tax and interest thereon collected from the Endowment for its fiscal years

ended June 30, 1979, 1980, and 1981, together with statutory interest thereon as provided by law:

<u>Year</u>	<u>Tax</u>	<u>Assessed Interest</u>	<u>Total</u>
1979	\$1,587,924.00	None assessed at time claim filed	\$1,587,924.00
1980	2,326,774.00	\$376,363.66	2,703,137.66
1981	2,105,709.00	None assessed at time claim filed	2,105,709.00
	\$6,020,407.00	\$376,363.66	\$6,396,770.66

### 3.

The Endowment asserts that it had no unrelated business income during the taxable years here involved and that the Commissioner of Internal Revenue ("the Commissioner") erred in classifying as unrelated business income funds received by the Endowment as contributions from members participating in its group insurance programs.

## III.

### *Identity and Tax Status of Plaintiff*

### 4.

The American Bar Endowment is a charitable corporation organized in 1942 under the laws of the State of Illinois with its principal office in Chicago, Illinois. All members of the American Bar Association ("ABA"), a professional association exempt from Federal income taxation under sections 501(a) and 501(c)(6) of the Internal Revenue Code of 1954, are, by virtue of their membership in the ABA, members of the Endowment.

### 5.

The Endowment was organized and has been operated for the purpose of receiving gifts, devises and contributions to be used for educational and charitable purposes in the field of law.

### 6.

The Endowment has to date made grants of over \$50 million for charitable work in the field of law, funding a large and diverse group of research, educational and other public service activities. In its fiscal years 1979, 1980, and 1981, the Endowment awarded grants in the following amounts:

<u>Year</u>	<u>Amount</u>
1979	\$3,602,462.00
1980	4,397,619.00
1981	4,640,000.00

The grant recipients included the American Bar Foundation, the ABA Fund for Public Education, the Institute of Judicial Administration, the Institute for Court Management, the National College of District Attorneys, the National Council of Juvenile and Family Court Judges, the National College of Criminal Defense Lawyers, the National Institute for Trial Advocacy, and the National Legal Aid and Defender Association.

### 7.

By letters dated March 30, 1944 and October 7, 1948, the Commissioner ruled that the Endowment was a charitable organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939. The Endowment retains such status under section 501(c)(3) of the Internal Revenue Code of 1954, Title 26 of the United States Code, as amended ("the Code"). This status was reaffirmed in a technical advice memorandum issued by the National Office of the Internal Revenue Service on July 3, 1980.



## IV.

*Sources of Charitable Funds*

## 8.

The Endowment has three sources of charitable funds, namely, individual gifts and bequests, investment of cash reserves, and contributions from members participating in its group insurance programs. Most of the grant funding capability of the Endowment is attributable to contributions from members participating in the group insurance programs.

## 9.

In the early 1950's, leaders of the ABA conceived the idea that providing group life insurance coverage for members could be a means of obtaining contributions from members to the Endowment for charitable and educational activities in the field of law. In furtherance of this goal, the Endowment's Board of Directors executed in 1955 a group life insurance contract with New York Life Insurance Company ("New York Life") insuring the lives of eligible members of the Endowment who elected to participate in the insurance program. Initially, only group life insurance coverage was available; the scope of coverage was broadened over time so that different types of insurance coverage were offered to members, including disability income, in-hospital indemnity, major medical, and accidental death and dismemberment coverage. The amounts of life insurance coverage that members could secure were also increased over the years and dependents' coverage was added.

## 10.

The Endowment is the group policyholder for each of its insurance programs. Each member who enrolls in a program makes a premium contribution to the Endow-

ment which in turn pays the gross premium for the program to the insurer. At the time of enrollment, each member agrees and acknowledges that any "dividends to the policyholder" apportioned to the life insurance program by New York Life, or "experience credits" paid on the other group policies by Mutual of Omaha Insurance Company ("Mutual of Omaha"), the insurance carrier for all programs other than life, will be paid to the Endowment.

## 11.

The receipt by the Endowment of dividends to policyholders and experience credits (hereinafter collectively referred to as ("premium refunds")) reduced *pro tanto* the cost of insurance provided to the members of the Endowment.

## 12.

In each of its fiscal years 1979, 1980, and 1981, the Endowment received the following aggregate amounts of premium refunds from New York Life and Mutual of Omaha:

<u>Year</u>	<u>Amount</u>
1979	\$5,132,662.00
1980	6,758,341.00
1981	6,860,190.00

## 13.

In each of the years 1979, 1980, and 1981, after receipt of premium refunds from New York Life and Mutual of Omaha, the Endowment, in accord with its customary practice, mailed a notice informing each insured member of the percentage of his or her premium contribution for the prior year that constituted the member's charitable contribution to the Endowment. In determining the percentages for each year that constituted charitable con-

tributions, the Endowment deducted its expenses of operation allocable to the administration of its insurance programs, as well as certain other expenses, from the premium refunds received from New York Life and Mutual of Omaha.

# V.

## *Contributions by Members*

### 14.

The central feature of the Endowment's group insurance programs is an agreement and understanding between the Endowment and its insured members that the premium refunds are to be retained by the Endowment and (after reimbursement of Endowment expenses) used for charitable purposes in the field of law, rather than returned to members or applied for their financial benefit. Each of the Endowment's group insurance programs was adopted and has been operated by it with the objective and expectation that a substantial percentage of the premium contributions received from members would be returned to the Endowment as premium refunds. But for this charitable feature of the programs, group insurance could have been made available to the members by the ABA with substantially reduced payments by the members.

### 15.

By making premium contributions to the Endowment and by foregoing the advantage of having premium refunds returned to them or applied for their financial benefit (after reimbursement of Endowment expenses), the insured members made contributions or gifts to the Endowment. These contributions or gifts did not constitute income to the Endowment within the meaning of the Code.

### 16.

The amount of the premium contributions furnished by insured members and paid by the Endowment as gross premiums to New York Life and Mutual of Omaha was substantially above the fair market value of the group insurance obtained.

### 17.

The value of group insurance obtained by the insured members can fairly be measured by the amount of the gross premium paid by the Endowment to the insurance company for the insurance plus the administrative expenses of the Endowment attributable to the group insurance program, less the amounts returned by the insurance company to the Endowment as premium refunds, or, otherwise stated, by the net amount of the premium paid to the insurer for the group insurance plus the attributable administrative expenses of the Endowment. The excess of the gross premium over the value of the group insurance determined in this manner represented the charitable contribution to the Endowment by insured members.

### 18.

During its fiscal years 1979, 1980, and 1981, in accord with the Endowment's customary practices, payments by insured members for participation in the group insurance programs were solicited by the Endowment with the assurance to members that these payments would be transmitted in full to the respective insurers and that amounts returned as premium refunds would be applied, after deduction of attributable expenses, to charitable purposes in the field of law. The Endowment has always applied such funds in accord with its commitment to its members. The Endowment never retained under a claim of right premium contributions received from members or

premium refunds received from insurers; to the contrary, such funds were restricted as to use or disposition. Thus, the receipt and retention of premium refunds did not constitute income to the Endowment.

## VI.

### *The Operation of the Group Insurance Programs*

#### 19.

The Endowment operated its group insurance programs during its fiscal years 1979, 1980, and 1981, for the sole purpose of securing contributions from its members for its educational and charitable purposes in the field of law. The Endowment does not receive any income from the sale of goods, nor from the performance of services. The administration of the voluntary group insurance programs by the Endowment was not designed or conducted as a commercial or competitive business undertaking.

#### 20.

The Endowment's voluntary group insurance programs do not compete, and have never competed, with commercial insurance companies. The Endowment does not operate as an insurance agent or broker in competition with commercial insurance brokers. Neither New York Life nor Mutual of Omaha has paid any compensation to the Endowment for its administration of the group insurance programs, or for any other reason. During all relevant periods the insurance broker for each of the group policies was a licensed insurance brokerage firm whose compensation was regularly paid on a commission basis by New York Life and Mutual of Omaha. The only activity engaged in by the Endowment with respect to its group insurance programs was in its capacity as group policyholder.

#### 21.

The Endowment did not carry on an unrelated trade or business in any of its fiscal years 1979, 1980, or 1981. The Endowment did not receive unrelated business income in any of these years. Premium refunds received and retained by the Endowment in each of these years did not constitute income to the Endowment.

#### 22.

Alternatively, only a small portion of the premium refunds received and retained by the Endowment in each of its fiscal years 1979, 1980, and 1981 could be deemed to constitute unrelated business income to the Endowment. Such portion could not exceed an amount sufficient to pay the Endowment a reasonable commercial charge for any services it rendered in connection with its insurance programs. The Endowment deducted from premium refunds each year all expenses attributable to its group insurance programs (and certain other expenses) before determining the amounts constituting charitable contributions from its insured members. The amounts deducted by the Endowment for such expenses were not less than and, in fact, exceeded a reasonable commercial charge (including a reasonable profit) for all services rendered by the Endowment in connection with its group insurance programs. Thus, no additional amounts should be attributed to the Endowment as income.

## VII.

### *Assertion and Payment of Deficiencies*

#### 23.

On February 25, 1972, the National Office of the Internal Revenue Service issued a technical advice memorandum setting forth its determination that the Endowment's



activities in connection with its group insurance programs did not constitute an unrelated trade or business within the meaning of section 513 of the Code and that the Endowment's receipt of premium refunds was not subject to the unrelated business income tax imposed by section 511 of the Code. This determination of the Internal Revenue Service was reiterated in a technical advice memorandum issued on January 30, 1973 as a substitute for the February 25, 1972 technical advice memorandum.

## 24.

Despite its favorable opinions of February 25, 1972 and January 30, 1973, the National Office of the Internal Revenue Service issued a technical advice memorandum on July 3, 1980, which reversed the 1973 technical advice memorandum and determined that the Endowment's activities in connection with its group insurance programs constituted an unrelated trade or business, and that premium refunds received by the Endowment were gross income from an unrelated trade or business.

## 25.

The Commissioner caused the Endowment's returns for its fiscal years 1979 and 1980 to be audited and, as a result of such audits, asserted against the Endowment unrelated business income tax deficiencies for such years, which were paid to the Internal Revenue Service as follows:

	<u>1979</u>	<u>Date Paid</u>	<u>1980</u>	<u>Date Paid</u>
Principal payments:	\$1,587,000.00	3/2/82	\$2,326,774.00	3/2/82
	\$924.00	7/8/82		
Interest payments:	—	—	\$376,363.66	7/8/82

## 26.

On March 2, 1982, the Endowment, which previously had filed its tax return for the 1981 fiscal year showing no tax liability, paid \$2,105,709.00 in unrelated business income tax to the Internal Revenue Service. Such amount was computed on the same basis as that used in computing the alleged deficiencies for 1979 and 1980. No interest had been assessed on that payment at the time of filing the claim for refund for 1981 on which this petition is based.

## VIII.

*Filing and Disallowance of Claim for Refund*

## 27.

On July 15, 1982, the Endowment filed with the Director of the Regional Service Center in Kansas City, Missouri, Claims for Refund, consisting of Forms 990-T accompanied by a statement of facts and grounds upon which the refund was sought for each of its fiscal years 1979, 1980, and 1981. These claims were filed within the time prescribed by law and set forth the grounds upon which this suit is brought.

## 28.

On August 6, 1982 the Commissioner mailed by certified mail a notice of disallowance in full of the Claims for Refund for each of the Endowment's fiscal years 1979, 1980, and 1981. This suit is brought within the time prescribed by law.

## IX.

*Overpayment of Taxes*

## 29.

For the reasons set forth herein, the Endowment has overpaid the tax imposed by section 511 of the Code for

each of its fiscal years 1979, 1980, and 1981 and there is now due and owing from the United States to the Endowment the sum of \$6,020,407.00, together with interest assessed and paid thereon in the amount of \$376,363.66, plus statutory interest thereon from the dates of payment thereof.

**X.**

*Refund Not Made*

**30.**

Although repayment thereof has been demanded, no part of the sum of \$6,396,770.66 has been credited, remitted, refunded, or repaid to the Endowment or to anyone on its account.

WHEREFORE, Plaintiff, the American Bar Endowment, prays for judgment in its favor against Defendant, the United States of America, in the amount of \$6,396,770.66, or such other amount as this Honorable Court may determine, together with interest thereon as provided by law from the dates of payment thereof, together with the costs of this action, and for such other relief as may to this Honorable Court seem just and proper.

Respectfully submitted,

FRANCIS M. GREGORY, JR.

**In the United States Court of Claims**

Docket No. 465-82T

AMERICAN BAR ENDOWMENT, PLAINTIFF,

v.

UNITED STATES OF AMERICA, DEFENDANT.

**ANSWER**

(Filed: FEB 11, 1983)

Defendant, the United States, in answer to the petition in the above-captioned case, respectfully denies each and every allegation contained therein not admitted, qualified, or expressly referred to below.

Defendant further:

1-2. Admits the allegations contained in paragraphs 1 and 2.

3. Denies that the Endowment had no unrelated business taxable income for the taxable years involved. Denies that the Commissioner erred in classifying funds received as a result of the Endowment's group insurance program as unrelated business taxable income.

4. Admits the allegations contained in paragraph 4.

5. Admits the allegations contained in paragraph 5, except denies that plaintiff operated exclusively for these purposes.

6. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 6.

7. Admits the allegations contained in paragraph 7.

8. Admits the allegations contained in paragraph 8, except denies that the amounts received by the Endowment from insurance companies constitute "contributions."

9. Admits the allegations contained in paragraph 9, except denies that American Bar Association conceived the idea of providing group insurance in order to receive "contributions."

10. Admits the allegations contained in paragraph 10, except denies that the premiums paid by insured members are in any sense "contributions."

11. Denies the allegations contained in paragraph 11.

12. Admits the allegations contained in paragraph 12 as to 1979 and 1980, except states that the plaintiff received dividends and experience credits—not premium refunds. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations concerning 1981.

13. Denies the allegations contained in paragraph 13 to the extent it suggests that the plaintiff received either contributions or premium refunds. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the remainder of the allegations contained in paragraph 13.

14-17. Denies the allegations contained in paragraphs 14 through 17.

18. With respect to the first sentence of paragraph 18, admits that plaintiff solicited participation in the insurance program; denies that plaintiff received premium refunds; states that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the remaining allegations contained in this sentence. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in the second and third sentences of paragraph 18. Denies the allegations contained in the fourth sentence of paragraph 18.

19. Denies the allegations contained in paragraph 19.

20. Denies the allegations contained in the first three sentences of paragraph 20. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in the fourth sentence of paragraph 20. Denies the allegations contained in the fifth sentence of paragraph 20.

21. Denies the allegations contained in paragraph 21.

22. Denies the allegations contained in the first two sentences of paragraph 22. Denies the allegations contained in the third sentence to the extent it suggests that the plaintiff received either contributions or premium refunds. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the remainder of the allegations contained in the third sentence. Denies the allegations contained in the fourth and fifth sentences of paragraph 22.

23-24. States that these paragraphs require no response. A closing agreement executed by the plaintiff on May 24, 1982, and by the Internal Revenue Service on June 15, 1982, states in part as follows:

For its fiscal years ended June 30, 1979 and June 30, 1980, Endowment will not be granted section 7095(b) relief, and Endowment agrees that neither it nor any other party which joins with it in litigation of the issues arising from its group insurance program will raise or allow to be raised either in claims for refund or in the litigation any claims for relief under section 7805(b), or any theory such as estoppel, reliance, or abuse of discretion, or any similar theory which relates to the manner in which Endowment's liability for the unrelated business income tax was determined as opposed to the merits of the tax;

25. Admits the allegations contained in paragraph 25.

26. Admits the allegations contained in the first sentence of paragraph 26. States that its attorneys presently lack



knowledge or information sufficient to form a belief as to the truth of the allegations contained in the second sentence. Admits the allegations contained in the third sentence of paragraph 26.

27-28. Admits the allegations contained in paragraphs 27 and 28.

29. Denies the allegations contained in paragraph 29.

30. Admits the allegations contained in paragraph 30.

WHEREFORE, defendant requests that the petition be dismissed, with all allowable costs assessed against plaintiff.

Respectfully submitted,

ROBERT E. DAVIS  
Acting Assistant Attorney General

## In the United States Court of Claims

Docket No. 465-82T

AMERICAN BAR ENDOWMENT, PLAINTIFF,

v.

UNITED STATES OF AMERICA, DEFENDANT.

### FIRST AMENDED ANSWER

(Filed: March 10, 1983)

Defendant, the United States, in answer to the petition in the above-captioned case, respectfully denies each and every allegation contained therein not admitted, qualified, or expressly referred to below.

Defendant further:

1-2. Admits the allegations contained in paragraphs 1 and 2.

3. Denies that the Endowment had no unrelated business taxable income for the taxable years involved. Denies that the Commissioner erred in classifying funds received as a result of the Endowment's group insurance program as unrelated business taxable income.

4. Admits the allegations contained in paragraph 4.

5. Admits the allegations contained in paragraph 5, except denies that plaintiff operated exclusively for these purposes.

6. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 6.

7. Admits allegations contained in paragraph 7.

8. Admits the allegations contained in paragraph 8, except denies that the amounts received by the Endowment from insurance companies constitute "contributions."

9. Admits the allegations contained in paragraph 9, except denies that American Bar Association conceived the idea of providing group insurance in order to receive "contributions."

10. Admits the allegations contained in paragraph 10, except denies that the premiums paid by insured members are in any sense "contributions."

11. Denies the allegations contained in paragraph 11.

12. Admits the allegations contained in paragraph 12 as to 1979, except states that the plaintiff received dividends and experience credits—not premium refunds. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations concerning 1980 and 1981.

13. Denies the allegations contained in paragraph 13 to the extent it suggests that the plaintiff received either contributions or premium refunds. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the remainder of the allegations contained in paragraph 13.

14-17. Denies the allegations contained in paragraphs 14 through 17.

18. With respect to the first sentence of paragraph 18, admits that plaintiff solicited participation in the insurance program; denies that plaintiff received premium refunds; states that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the remaining allegations contained in this sentence. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in the second and third sentences of paragraph 18. Denies the allegations contained in the fourth sentence of paragraph 18.

19. Denies the allegations contained in paragraph 19.

20. Denies the allegations contained in the first three sentences of paragraph 20. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in the fourth sentence of paragraph 20. Denies the allegations contained in the fifth sentence of paragraph 20.

21. Denies the allegations contained in paragraph 21.

22. Denies the allegations contained in the first two sentences of paragraph 22. Denies the allegations contained in the third sentence to the extent it suggests that the plaintiff received either contributions or premium refunds. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the remainder of the allegations contained in the third sentence. Denies the allegations contained in the fourth and fifth sentences of paragraph 22.

23-24. States that these paragraphs require no response. A closing agreement executed by the plaintiff on May 24, 1982, and by the Internal Revenue Service on June 15, 1982, states in part as follows:

For its fiscal years ended June 30, 1979 and June 30, 1980, Endowment will not be granted section 7095(b) relief, and Endowment agrees that neither it nor any other party which joins with it in litigation of the issues arising from its group insurance program will raise or allow to be raised either in claims for refund or in the litigation any claims for relief under section 7805(b), or any theory such as estoppel, reliance, or abuse of discretion, or any similar theory which relates to the manner in which Endowment's liability for the unrelated business income tax was determined as opposed to the merits of the tax;

25. Admits the allegations contained in paragraph 25.

26. Admits the allegations contained in the first sentence of paragraph 26. States that its attorneys lack knowledge

or information sufficient to form a belief as to the truth of the allegations contained in the second sentence. Admits the allegations contained in the third sentence of paragraph 26.

27-28. Admits the allegations contained in paragraphs 27 and 28.

29. Denies the allegations contained in paragraph 29.

30. Admits the allegations contained in paragraph 30.

WHEREFORE, defendant requests that the petition be dismissed, with all allowable costs assessed against plaintiff.

Respectfully submitted,

ROBERT E. DAVIS  
Acting Assistant Attorney General

## In the United States Court of Claims

Docket No. 465-82T

AMERICAN BAR ENDOWMENT, PLAINTIFF,

v.

UNITED STATES OF AMERICAN, DEFENDANT.

### FIRST AMENDMENT TO COMPLAINT OF PLAINTIFF AMERICAN BAR ENDOWMENT

(Filed: July 18, 1983)

The Complaint of plaintiff American Bar Endowment is amended by striking paragraphs 2, 25, 26, 27, 28, 29, and 30 and the accompanying prayer for relief, and by inserting, in lieu thereof, the following paragraphs 2, 25, 26, 27, 28, 29, and 30 and accompanying prayer for relief:

#### 2.

This action is brought for the recovery of the following amounts of unrelated business income tax and interest thereon collected from the Endowment for its fiscal years ending June 30, 1979, 1980, and 1981, together with statutory interest thereon as provided by law:

<u>Year</u>	<u>Tax</u>	<u>Interest</u>	<u>Total</u>
1979	\$1,587,924.00	\$427,845.18	\$2,015,769.18
1980	2,326,774.00	376,363.66	2,703,137.66
1981	2,105,709.00	87,459.04	2,193,168.04
	\$6,020,407.00	\$891,667.88	\$6,912,074.88



## 25.

The Commisioner caused the Endowment's returns for its fiscal years 1979, 1980, and 1981 to be audited and, as a result of such audits, asserted against the Endowment unrelated business income tax deficiencies for such years, which were paid to the Internal Revenue Service as follows:

<u>Year</u>	<u>Principal Payment</u>	<u>Date Paid</u>	<u>Interest Payment</u>	<u>Date Paid</u>
1979	\$1,587,000.00	3/2/82	\$427,845.15	11/2/82
	924.00	7/8/82		
1980	2,326,774.00	3/2/82	376,363.66	7/8/82
1981	2,105,709.00	3/2/82	—	—

## 26.

On December 30, 1982, the Endowment, which previously had paid \$2,105,709.00 in unrelated business income tax for its 1981 fiscal year to the Internal Revenue Service, paid \$87,459.04 in interest on that payment. Such amount of interest was computed based on the \$2,105,709.00 in unrelated business income tax for the Endowment's 1981 fiscal year paid to, and subsequently assessed by, the Internal Revenue Service.

## 27.

On July 15, 1982, the Endowment filed with the Director of the Regional Service Center in Kansas City, Missouri, Claims for Refund, consisting of Forms 990-T accompanied by a statement of facts and grounds upon which the refund of tax paid for each of its fiscal years 1979, 1980, and 1981, and the refund of interest paid for its fiscal year 1980 was sought. On December 30, 1982, the Endowment filed with the Director of the Regional Service

Center in Kansas City, Missouri, Claims for Refund of interest, consisting of amended Forms 990-T accompanied by a statement of facts and grounds upon which the refund of interest paid for its fiscal years 1979 and 1981 was sought. All such claims were filed within the time prescribed by law and set forth the grounds upon which this suit is brought.

## 28.

On August 6, 1982, the Commissioner mailed by certified mail a notice of disallowance in full of the Claims for Refund filed on July 15, 1982. Six months have passed without final action by the Internal Revenue Service on the Claims for Refund filed on December 30, 1982. This suit is brought within the time prescribed by law.

## 29.

For the reasons set forth herein, the Endowment has overpaid the tax imposed by section 511 of the Code for each of its fiscal years 1979, 1980, and 1981 and there is now due and owing from the United States to the Endowment the sum of \$6,020,407.00, together with interest paid thereon in the amount of \$891,667.88, plus statutory interest thereon from the dates of payment thereof.

## 30.

Although repayment thereof has been demanded, no part of the sum of \$6,912,074.88 has been credited, remitted, refunded, or repaid to the endowment or to anyone on its account.

WHEREFORE, Plaintiff, the American Bar Endowment, prays for judgment in its favor against defendant, the United States of America, in the amount of \$6,912,074.88, or such other amount as this Honorable

Court may determine, together with interest thereon as provided by law from the dates of payment thereof, together with the costs of this action, and for such other relief as may to this Honorable Court seem just and proper.

Respectfully submitted,

/s/ FRANCIS M. GREGORY, JR.

Francis M. Gregory, Jr.

## In the United States Court of Claims

Docket No. 465-82T

AMERICAN BAR ENDOWMENT, PLAINTIFF,

v.

UNITED STATES OF AMERICA, DEFENDANT.

### ANSWER TO FIRST AMENDMENT TO COMPLAINT OF PLAINTIFF AMERICAN BAR ENDOWMENT

(Filed: July 28, 1983)

Defendant, the United States, by its attorneys, in answer to the first amendment to plaintiff's complaint, filed in the above-entitled case, respectfully denies every allegation contained therein, not admitted, qualified, or expressly referred to below.

Defendant, in further response to the amended complaint, strikes its responses to paragraphs 2, 25, 26, 27, 28, 29, and 30 of its answer filed February 11, 1983, and substitutes therefor its responses to the amended complaint as follows:

2. Admits the allegations contained in paragraph 2.

25. Admits the allegations contained in paragraph 25, except states that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations concerning the payment of \$427,845.15 in interest for the year 1979.

26. Admits that, previous to December 30, 1982, the Endowment paid \$2,105,709 in unrelated business income tax for its 1981 fiscal year. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the remaining allegations contained in paragraph 26.

27. Admits the allegations contained in the first sentence of paragraph 27. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the remaining allegations contained in the second sentence of paragraph 27. As to the third sentence of paragraph 27, admits that the claims filed on July 15, 1982, were filed within the time prescribed by law and set forth the grounds upon which this suit is brought; states that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations of the third sentence of paragraph 27 as they relate to the claims alleged to have been filed December 30, 1982.

28. Admits the allegations contained in the first sentence of paragraph 28. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in the second and third sentences of paragraph 28.

29. Denies the allegations contained in paragraph 29.

30. With respect to paragraph 30, admits that the sums of \$6,020,407 in tax and \$376,363.66 in interest have not been refunded or repaid to the Endowment or anyone in its behalf. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegation contained in paragraph 30 concerning interest assessed and paid in excess of the sum of \$376,363.66.

WHEREFORE, defendant requests that the complaint be dismissed, with all allowable costs assessed against plaintiff.

Respectfully submitted,

/s/ ROBERT EDWIN DAVIS

ROBERT EDWIN DAVIS

Acting Assistant Attorney General

## In the United States Court of Claims

Docket No. 163-83T

FREDERICK D. TURNER AND MARGARET S. TURNER,  
PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT.

### Complaint

(Filed: MAR 21, 1983)

To the Honorable Judges of the United States Claims Court:

Plaintiffs, Frederick D. Turner (SS No. 001-30-9135) and Margaret S. Turner (SS No. 055-32-8815), bring this action and respectfully allege:

I.

1.

### Jurisdiction

This is action under the Internal Revenue Laws of the United States and is brought pursuant to section 1491 of Title 28 of the United States Code, as amended.

II.

2.

### Refund Claimed

This action is brought for the recovery of income tax in the amount of \$25.00 collected from the plaintiffs, together with statutory interest thereon as provided by law



## III.

## 3.

*Identity of Plaintiffs*

Plaintiffs are husband and wife. Frederick D. Turner (hereinafter "Plaintiff") is a partner in the Buffalo, New York law firm of Brown, Kelly, Turner, Hassett & Leach. Margaret S. Turner is Executive Director of the Buffalo, New York office of the American Lung Association.

## IV.

*Payment of Taxes*

## 4.

On July 26, 1981, pursuant to extension, Plaintiffs filed a joint Federal income tax return with the Internal Revenue Service Center in Andover, Massachusetts for the year ending December 31, 1980. The 1980 return showed an income tax liability of \$21,623 which was paid as follows:

Estimated tax payments:	\$16,000
Paid with Form 4868	2,223
Withholding	2,777
With return	623

## V.

## 5.

Plaintiff is a member of the American Bar Endowment (hereafter the "Endowment") whose by-laws provide that its membership consists of the members in good standing of the American Bar Association (hereafter the "ABA"). The Endowment is a charitable corporation exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code.

## 6.

Plaintiff enrolled, effective December 1, 1972, for \$20,000 of life insurance coverage under a group life insurance policy owned by the Endowment and issued by New York Life Insurance Company ("New York Life"). Before enrolling for coverage under the group life insurance policy, Plaintiff reviewed Endowment literature describing the insurance plan, its charitable purposes, and the Endowment's commitment to expend its funds for charitable work in the field of law; Plaintiff signed a statement agreeing and acknowledging that any dividends apportioned to the policy by New York Life would be paid to the Endowment.

## 7.

In each of the years since Plaintiff enrolled in the life insurance plan, the Endowment has received a dividend apportioned to the policy by New York Life. This dividend was the result of premium payments in the year prior to the receipt of the dividend. For all years following the first year of Plaintiff's enrollment, the Endowment, after receipt of the dividend, has mailed a notice to Plaintiff informing him of the percentage of his prior payment which constituted his charitable contribution to the Endowment.

## 8.

In each of the years since Plaintiff enrolled in the life insurance plan, he has paid the applicable annual premium to the Endowment. For the group life premium payment period extending from December 1, 1978 to November 30, 1979, Plaintiff paid to the Endowment a premium of \$100.00, semi-annual payments of \$50.00 being made on November 15, 1978 and May 27, 1979. For the premium payment period extending from December 1, 1979 to November 30, 1980, Plaintiff paid to the Endowment a

premium of \$100.00, semi-annual payments of \$50.00 being made on December 1, 1979 and May 5, 1980. For the premium payment period extending from December 1, 1980 to November 30, 1981, Plaintiff paid to the Endowment a premium of \$100.00, semi-annual payments of \$50.00 being made on November 4, 1980 and May 20, 1981.

## 9.

In 1980 Plaintiff received a written notice from the Endowment, which had received a dividend from New York Life in that year, advising that each insured member had in 1980 made a contribution to the Endowment of 49.3% of any life insurance premiums paid in the period from December 1, 1978 to November 30, 1979. In 1981 taxpayer received a similar notice from the Endowment, which had received a dividend from New York Life in that year, advising that in 1981 each insured member had made a contribution to the Endowment of 55.4% of any life insurance premiums paid in the period from December 1, 1979 to November 30, 1980.

## VI.

*Charitable Contribution*

## 10.

In 1980 Plaintiffs were entitled to deduct as a charitable contribution to the Endowment for use in its charitable activities in the field of law 49.3% of life insurance premiums paid by Plaintiff in the period from December 1, 1978 to November 30, 1979.

## 11.

Alternatively, in 1980 Plaintiffs were entitled to deduct as a charitable contribution to the Endowment that portion of life insurance premiums paid by Plaintiff in 1980 that was returned to the Endowment subsequent to 1980 for use in its charitable activities in the field of law.

## VII.

*Overpayment of Taxes*

## 12.

In filing their Federal income tax return for 1980, Plaintiffs failed to deduct as a charitable contribution within the meaning of section 170(c)(2) of the Internal Revenue Code that amount of life insurance premiums paid by Plaintiff that constituted a charitable contribution.

## 13.

For the reasons set forth herein, Plaintiffs have overpaid their income tax for 1980 and there is now due and owing from the defendant to the plaintiffs the sum of \$25.00 and statutory interest thereon.

## VIII.

*Filing and Denial of Claim for Refund*

## 14.

On September 17, 1982, Plaintiffs timely filed with the Internal Revenue Service Center, Andover, Massachusetts, a claim for refund of income tax paid for 1980. Such claim set forth the grounds and reasons upon which this suit is brought.

## 15.

Six months have passed without final action by the Internal Revenue Service on Plaintiffs' claim.

\* \* \* \* \*

WHEREFORE, Plaintiffs demand judgment against the Defendant, the United States of America, in the amount of \$25.00, or such other amount as this

Honorable Court may determine, together with interest thereon as provided by law from the dates of payment thereof, together with the costs of this action, and for such other relief as the Honorable Court may deem just and proper.

Respectfully submitted,

/s/ FRANCIS M. GREGORY, JR.  
Francis M. Gregory, Jr.

## In the United States Court of Claims

---

Docket No. 163-83T

---

FREDERICK D. TURNER AND MARGARET S. TURNER,  
PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT.

---

Answer

(Filed: MAY 20, 1983)

---

Defendant, the United States, in answer to the complaint in the above-captioned case, respectfully denies each and every allegation contained therein not admitted, qualified, or expressly referred to below.

Defendant further:

1-4. Admits the allegations contained in paragraphs 1 through 4.

5. Admits the allegations contained in the first sentence of paragraph 5. With respect to the second sentence, admits that the Internal Revenue Service has ruled that the Endowment is a charitable corporation exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code.

6. Admits the allegations contained in the first sentence of paragraph 6. With respect to the second sentence, states that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of whether, before enrolling for coverage under the group life insurance policy, plaintiff Frederick D. Turner (hereafter plaintiff) reviewed Endowment literature describing the insurance plan, its charitable purposes, and the Endowment's commitment to expend its funds for charitable



work in the field of law. Admits that plaintiff signed a statement, at the time he purchased the insurance, agreeing and acknowledging that any dividends apportioned to the policy by New York Life would be paid to the Endowment.

7. Admits the allegations contained in the first sentence of paragraph 7. Denies the allegations contained in the second sentence. Avers that the group policies issued to the American Bar Endowment are participating policies, which means that the Endowment, as group policyholder, is entitled to share in the divisible surplus of New York Life through the receipt of dividends as ascertained by New York Life. New York Life has no contractual obligation to the Endowment to pay a dividend of a particular size or to use any particular formula or factors in determining the amount of the dividend. With respect to the third sentence, defendant admits that plaintiff received notices during the taxable years ended December 31, 1974, through December 31, 1979, informing him of the percentage of his prior year's premium payment which American Bar Endowment auditors and counsel advised, in their opinion, constituted charitable contributions. Counsel advised, however, that the Internal Revenue Service had not ruled on the matter. Denies the remaining allegations contained in paragraph 7.

8. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 8.

9. With respect to paragraph 9, defendant admits that in 1980 plaintiff received a written notice from the Endowment, which had received a dividend from New York Life in that year, advising that, in the opinion of their auditors and counsel, each insured member had in 1980 made a contribution to the Endowment of 49.3 percent of any life insurance premiums paid in the period from December 1, 1978, to November 30, 1979. Counsel, however, further

advised in the notice that the Internal Revenue Service had ruled that members were not entitled to charitable contributions for any portion of their premium payments. Defendant further admits that in 1981 plaintiff received a similar notice from the Endowment, which had received a dividend from New York Life in that year, advising that, in the opinion of the Endowment's auditors and counsel, in 1981 each insured member had made a contribution to the Endowment of 55.4 percent of any life insurance premiums paid in the period from December 1, 1979, to November 30, 1980.

10-11. Denies any allegations contained in paragraphs 10 and 11.

12. Admits the allegations contained in paragraph 12, except denies that plaintiff was entitled to a charitable contribution deduction for any portion of the life insurance premiums.

13. Denies the allegations contained in paragraph 13.

14-15. Admits the allegations contained in paragraphs 14 and 15.

WHEREFORE, defendant requests the complaint be dismissed, with all allowable costs assessed against plaintiffs.

Respectfully submitted,

/s/ ROBERT EDWIN DAVIS

ROBERT EDWIN DAVIS

Acting Assisting Attorney General

## In the United States Claims Court

No. 465-82T, 163-83T, 190-83T, 320-83T, 351-83T

AMERICAN BAR ENDOWMENT, ET AL., PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

EXCERPTS FROM TRANSCRIPT OF PROCEEDINGS,  
MAY 12, 1983

\* \* \* \* \*

[3] THE COURT: Good morning, Mr. Sutherland. It is a real pleasure to have you here.

MR. SUTHERLAND: Thank you. It is a pleasure being here.

THE COURT: Well, this is a motion for summary judgement by the Defendant.

MR. DENNIS: Yes, Your Honor.

THE COURT: You may proceed, Mr. Dennis, or Mr. Markham; both.

MR. DENNIS: Thank you.

May it please the Court, the question presented in this case is whether the endorsement and administration of a group insurance program constitutes the business unrelated to an organization's exempt purpose under Section 511 through 513 of the Internal Revenue Code.

The Government moved for summary judgment in the incident case because it believed that there were no facts in dispute. It is our position that as matter of law, the administration and endorsement of a group insurance program constitutes the carrying on of a business unrelated to the organization's exempt purpose.

THE COURT: What exactly is that business?

MR. DENNIS: What is the business?

THE COURT: Yes. What business is that?

[4] MR. DENNIS: That they are engaged in? The Plaintiff operates as a group policy holder. In the petition, Paragraph 9, it stated that the Plaintiff provides five types of group insurance to its members.

THE COURT: So what are you saying? It is an insurance company?

(Pause)

What is the business we are talking about? Do they underwrite insurance?

MR DENNIS: They don't underwrite insurance.

THE COURT: So they are not an insurance company.

MR. DENNIS: They don't sell insurance.

THE COURT: They are not an insurance broker.

MR. DENNIS: But they endorse and administer an insurance program.

THE COURT: All right. So what then is the business? Endorser and administrator?

MR. DENNIS: Yes, and they are creating a market.

THE COURT: Market-maker?

MR. DENNIS: Yes.

THE COURT: Okay.

MR. DENNIS: For insurance.

THE COURT: Okay. So those are the relevant [5] businesses, according to you.

MR. DENNIS: Yes.

THE COURT: They are an administrator, a market-maker, and what was the third?

MR. DENNIS: And endorser of the insurance, which necessarily relates to the making of a market for insurance.

THE COURT: Endorser means —

MR DENNIS: Promote.

THE COURT: A promoter.

MR. DENNIS: Um-huh.

THE COURT: Sort of like an advertising agency.

MR. DENNIS: Yes.

THE COURT: Okay. So those are the services; that is the business in question?

MR. DENNIS: Yes. And essentially they serve as a middleman between the members and the insurance carrier.

THE COURT: Okay. Now you think that under all circumstances that would be an—that income obtained from that would be unrelated business income?

MR. DENNIS: Yes, Your Honor.

THE COURT: How do you deal with DAV? Here they were selling trinkets. DAV—Disabled American Veterans, decision by Court of Claims; they were selling [6] trinkets.

I mean, just like any other business, they went according to the opinion they were in the markets selling goods, a very easy to understand kind of business, and yet Court of Claims held that as to some of those goods, even though they were making a profit, the profit was so outrageous that it wasn't really a business and as to other of those goods, they were making a profit that was not outrageous and in that case it might be a UBIT or UBTI—UBTI—and as to those profits that were not outrageous, there had to be an apportionment.

And we just had a decision April 12th from the Circuit affirming. So why isn't this just another business making outrageous profits and therefore exempt from UBTI?

I mean, unless you are willing to concede that they are making outrageous profits, in which case I would have to give summary judgment to Plaintiffs. If you are willing to concede that, then under DAV, summary judgement would have to go the other way.

If you don't concede that they are making outrageous profits, then we have a triable issue of fact. Isn't that the standard?

MR. DENNIS: Your Honor, the only evidence before the Court concerning profits in this case is the [7] Plaintiff's own statements in the American Bar Association Journal where they state—

THE COURT: That is how trials work, you see. The Plaintiff comes in and tells the Court what it thinks and the Defendant comes in and tells the Court what it thinks. But what you are saying is there is no dispute, there is nothing to try.

And if there is nothing to try, I am going to have to believe that they are making outrageous profits like they claim and grant them summary judgement.

MR. DENNIS: They haven't attached any affidavits demonstrating they have made outrageous profits. When you are saying outrageous profits, I think that all insurance—certainly insurance—

THE COURT: We are not in the insurance business, remember.

MR. DENNIS: Yes, but the group policy holders involved in the Fourth and Fifth Circuits cases—

THE COURT: But we are not selling insurance, remember. We are providing services, according to your own statement of fact of what the business is. They are providing administrative services.

They are providing promotional services and are a market-maker. That is the service provided. They don't provide insurance and while all of us may think [8] the insurance companies make too much money—I don't know whether they do or not, but there is always suspicion of that—this is not an insurance company.

This is a provider of an administrative service according to you.

MR. DENNIS: Yes, in exactly the same capacity as the provider of services in Carolina's Farm, Fourth Circuit, Louisiana Credit, Fifth Circuit, exactly the same situation.



THE COURT: Right. Louisiana Credit rejected the DAV test, the outrageous profit test, didn't it, and as much as I respect the Fifth Circuit cannot reverse me, whereas the Federal Circuit sure can.

MR. DENNIS: But I think the analysis of the Fifth Circuit in Carolina's Farm is appropriate here. I think we have an entirely different situation than that involved in Disabled American Veterans where we are marketing trinkets.

THE COURT: Why do you think trinkets are different? I mean, if you needed a trial on trinkets, don't we need a trial in a sophisticated service like providing of administrative and group services?

MR. DENNIS: To determine whether it is operated in a commercial fashion or not?

THE COURT: Yes.

[9] MR. DENNIS: I don't think that there is any need whatsoever to determine whether the incident activity was conducted in a commercial fashion.

THE COURT: Why do you say that?

MR. DENNIS: I would just like to go through some of the responses to the request for admissions that we have received from the Plaintiffs. First of all, I would like to move that their responses be made part of the record in this case.

The Plaintiff initially disputed that our statement of undisputed facts did not relate to the period in dispute. Also —

THE COURT: Let's not talk lawyer talk. Let's talk reality. Let's not talk admissions of fact and the like. What do you think is really at issue in this case?

Why do you think that a sophisticated business like providing of administrative and managerial and promotional services which is coupled with presumably a fund-raising function is the kind of enterprise which is any more susceptible to summary judgement than the selling of trinkets by the DAV?

I guess I don't understand. Isn't this essentially the sale of a much more sophisticated service?

MR. DENNIS: Yes. Necessarily it takes on a [10] commercial nature. Indeed, in Disabled American Veterans, there is a question whether it is of a commercial nature or not. When you are sending out a letter to individuals and you are saying that we would like a contribution, and you are entitled to a charitable contribution if you make a contribution.

THE COURT: In the DAV they were canvassing the world at large. Here they are limiting their canvassing to members only. In DAV, they were saying you get the trinkets if you make a contribution.

You don't have to be a member. You just kind of buy these trinkets at an outrageous cost. Here at least let's say you buy insurance, if I understand Plaintiff's contentions exactly, you are buying insurance at a cost much above market and essentially if you are willing to make a contribution to ABE, we will let you buy insurance.

I mean isn't that economic reality?

MR. DENNIS: It is carried on in a commercial fashion, though. That is the only question that DAV asked Carolina's Farm. I note that the endorsing and administration of group insurance is necessarily carried on in a commercial fashion because —

THE COURT: What do you mean "necessarily"?

MR. DENNIS: —there is advertisement and they [11] guaranteed remuneration albeit through a third party.

THE COURT: Nobody disputes that providing of administrative services can be a business, but do you dispute that under the law of the Circuit if you carry out a business which is coupled with a promotional function and the profits you make from that business is outrageous, or much more than the services you provide are worth, that in that case you are not subject to the UBTI?

MR. DENNIS: If you find that they carried on a business, no matter how outrageous the profits are, necessarily they are subject to the UBTI.

THE COURT: How do you get away from the \$2 and \$3 donations in DAV? The Circuit said the \$2 donations were worth less than a dollar, and they were getting \$2 for the 95-cent trinkets.

The \$3 donation brought you a \$1.49 worth of trinkets, and therefore those things were not really commercial transactions. They were promotional activities and as to the \$2 and \$3 transactions, even though there was a commercial aspect to it, the profits were so great that it really was not a commercial venture.

It didn't implicate the policy concerns of the UBTI because you didn't have a real competition with destructive, unfair competition with other providers of [12] the same service in the market.

Isn't Plaintiff's claim, generously viewed, essentially a claim that this is equivalent of the \$2 or \$3 transaction and taking Plaintiff's second level claim, isn't it saying that even if it does have commercial aspects to it, there must be an apportioning as there was with respect to the \$5 transactions in DAV?

Maybe there was a service provided here but some of the excess was profit and some of the excess was a charitable contribution, so that at the very least we ought to apportion.

MR. DENNIS: The Court in DAV was trying to ascertain whether there was a business or not with respect to the solicitation of contributions through low-cost items.

The question in DAV was: do we have a business? Your statement to me is: if you have a business and they have very high profits with respect to that business, are they subject to the tax under Section 513 of the Code?

Yes, they are, automatically. There is three questions under Section 513 of the Code. One, were they in a trade or business; two, was the trade or business regularly carried on; and three, was the trade or business substantially related to the organization's exempt [13] purpose.

Those are the only considerations under Section 513 of the Code. If the Court finds all three of those criteria are met in the incident case, the Government is entitled to judgement as a matter of law.

THE COURT: Well, the primary factors considered, I am quoting from DAV, is "when the Plaintiff conducted this activity in a competitive manner". Isn't that a test?

MR. DENNIS: Yes.

THE COURT: The question is not whether you are providing a service, but whether the service you are providing is one which is provided in a competitive manner.

Now, if—

MR. DENNIS: In order to determine whether they were in a business, and you are already agreeing that the Plaintiff was in a business, that the activities of the Plaintiff constituted a business.

THE COURT: Mr. Dennis, you have it turned around. I am the Judge. I am not a party. I don't agree or disagree to anything.

MR. DENNIS: I'm sorry. Your question to me, Your Honor, was if they are in a business.

[14] THE COURT: They are in an enterprise. They are doing something. The question is whether or not, according to the test in DAV, whether or not they are doing it in a commercial fashion.

And if I understand Plaintiff's claim, they are just saying we are making such outrageous profits and we are getting such outrageous returns from the ABE, from the insurance companies, that whatever service we are providing is merely a vehicle for the raising of contributions.



This is just the way—

(Pause)

Another thing about this, and that is these are very sophisticated little enterprises we are dealing with. First of all we are dealing with economics of charitable organizations.

And there are all sorts of ways to get your people to dig into their pockets. One of them is called fool them. You get them to dig their hands into their pockets by offering them some service which they may or may not otherwise need and then while they have their hands in their pocket, they reach in and give a little more.

That was the \$2 and \$3 trinkets in DAV. You are in your pocket anyway; why don't you pull out more, [15] much more, than the service is worth. So what the service is really being used for is not necessarily to make a profit on the service itself, but is a way of prying open the pocket.

So when you have the pocket open, you can get them to pull out a little more. But you are also dealing with insurance, a very sophisticated business, isn't it?

MR. DENNIS: Yes.

THE COURT: What you have is group insurance, right, which is different from individual insurance. You have insurance companies vying for the service, the ability to capture a group as its market.

On the other hand, you have members who would like to be members of a group who perhaps want to buy insurance at group rates. How can I really on the basis of summary judgement motions assess where in this very sophisticated little set of transactions this particular activity fits in?

MR. DENNIS: Well, I think the first way to approach the problem is to consider that with respect to the unrelated business tax, there is really two separate questions.

THE COURT: Okay.

MR. DENNIS: The first question is one of [16] liability under Section 513 and the second question is one of the amount of income under Section 512 of the Code.

THE COURT: Right.

MR. DENNIS: If you look at the liability question under Section 513, there is three questions that are presented under Section 513.

THE COURT: Right.

MR. DENNIS: First of all, did the Plaintiff engage in a business, a trader [*sic*] business.

THE COURT: Right.

MR. DENNIS: Secondly, was that—

THE COURT: And we know that you can make money selling things and still not engage in a trader [*sic*] business. The way we know that is the Court of Claims has told us that, don't we?

(Pause)

DAV said you can sell things in the market and still not engage in a trader [*sic*] business.

MR. DENNIS: Yes, if it is not carried on in a commercial—

THE COURT: Wait a minute. Let's take it in small increments. You can be selling something and still not be a trader [*sic*] business, okay? Now—

MR. DENNIS: I don't know if you can be selling [17] something. Selling necessarily takes on a trader [*sic*] business connotation. I think that you can be offering a low-cost item in exchange and not be in a trader [*sic*] business, but I don't know if I would go so far as to say that they are selling.

If you find selling, I think that you would be in a trader [*sic*] business.

THE COURT: All right. Well, let's not use the word "selling" if you feel uncomfortable with it. You can engage in the exchange of a good or service for money, quid pro



quo, and do essentially what a noncharitable organization would be doing if they were selling things: you give something and you get something in return.

And if you make enough money on it, if you just make enough money on it, if your profits are just outrageous enough, then you are not really engaging in a trader [*sic*] business.

The Circuit has said that, and the Court of Claims has.

MR. DENNIS: I think you have to look at that decision concerning the amount of money that has been made in light of the items being sold. I think that with the endorsement and administration of a group insurance policy, I think you have an entirely [18] different question.

There we obviously have a business; obviously the Plaintiff is creating a market for its insurance. It extensively advertised. It was guaranteed a profit.

THE COURT: But again it is not an insurance company. They are a provider of a service.

MR. DENNIS: Yes, it is a middleman. As the Tax Court, as the Fourth Circuit in Carolina's Farm, as the Fifth Circuit in Louisiana Credit, all held it is a middleman.

It is creating a market as a group policyholder. And that necessarily constitutes a business.

THE COURT: It doesn't necessarily constitute a business. If you are selling a service, a middleman service, at such outrageous rates that is not a commercial venture, why isn't it just like selling trinkets in DAV?

You have this middleman service that you can provide. You don't provide it at commercial rates. You don't provide it competitively with anybody else. You provide it at outrageous rates.

It is a way of prying open the pocket.

MR. DENNIS: It is the Government's position that when you are just focusing on the business question—

THE COURT: You don't like DAV.

[19] MR. DENNIS: I am perfectly comfortable with DAV. In fact, I agree with the result in DAV. The Government won.

(Pause)

THE COURT: Okay, if you think so. We didn't win everything.

MR. DENNIS: No, but I think DAV provides the correct result with respect to that type of item.

THE COURT: What do you mean, are you going to limit DAV to trinkets and disabled veterans and—

MR. DENNIS: Yes. I think the endorsement and administration of a group insurance program is just obviously different from the type of transaction—

THE COURT: What do you mean obviously different? They have different names. It is a more sophisticated service which points out that in understanding its value it may be necessary to take more evidence in deciding what the value of the trinkets is.

Judge Merow may be perfectly able to, as he was, to tell the value of a \$5 trinket, you know, listening to a few witnesses. I may need economists in here to tell me the true value of the kind of administrative and promotional services engaged in by the Plaintiff here.

It is a very sophisticated service. Just to [20] understand what the service is is a burden, much less to try to assign to it a market value on the basis of—now, I am not quite sure I understand: are you agreeing for the purposes of a summary judgement motion that in fact the amount of dividends and experience credits that ABE was getting back were far in excess of the value of the services provided?

Are you conceding that, either for purposes of a summary judgement motion or for purposes of the case?

MR. DENNIS: I concede for purposes of the case entirely that the value of the services, that the amount of money that they receive from the insurance program was vastly in excess of their expenses.

The Government will concede that for purposes of the cases.

THE COURT: But that is not the question I asked. The question was not whether it was vastly in excess of expenses. The question was it vastly in excess of the value of the services which they provided.

MR. DENNIS: It would be vastly in excess of the administrative services, the value of the administrative services also.

THE COURT: Wait a minute, Mr. Dennis. You have defined to me what they do and I have not argued with [21] you on that. You said they provide promotional services. They provide administrative services, and they provide a market. Those are commodities.

People are in the business of providing those things for profits. The question I am asking you: given the commodities that they are selling, that they are providing, as you have defined it, are you willing to concede for purposes of the cases, or purposes of the summary judgement motion, or for any other purpose, that the amount of income they had as a result of the experience credits and dividends is far in excess of the value of the services that they have provided?

(Pause)

Let me just tell you before you concede because if you tell me you are conceding for purposes of the case, I am going to ask Mr. Gregory to move for summary judgement the other way and we will just pack this thing up and send it to the Circuit.

MR. DENNIS: The Government's position is that when you are talking about what is being provided, that you have to look at the value of the insurance, that you don't look at the value of the administrative services.

THE COURT: I realize that, Mr. Dennis, but I disagree with you on that because you yourself have said [22] this is not an insurance company. They don't provide insurance services. They provide administrative and marketing and promotional services.

This is what they provide according to what you yourself has said. You can't look at some other commodity provided by some other company to decide what the value is.

What I am asking is do you concede for purposes of the case or otherwise that—or for purposes of the motion—that the amount of or the value or the service that they provide as a market-maker, as a promoter, or as an administrator of the group insurance fund, however you want to define the commodity, is a small fraction of the amount which they get from the experience credits and the dividends.

Or conversely, that the dividends and experience credits that they get from the companies are vastly in excess of the value of services that the firm provides. Are you willing to concede that?

MR. DENNIS: Could I have a moment, Your Honor?

THE COURT: Of course.

(Pause while Government Counsel confers with his colleague)

MR. DENNIS: Your Honor, in view of your comments, [23] the Government withdraws its motion for summary judgement and will develop the facts along the lines that you deem relevant in the case.

THE COURT: I thought it was you who deemed it relevant. No, I'm kidding. That's fine. Let me ask Mr. Gregory a few questions since we have him here anyway.

You have raised the question of a triable issue of fact, Mr. Gregory, open [*sic*] the question of whether or not these funds were income at all because they were trust funds or they were held in trust.

I have a good bit of trouble with that argument and I think I have been candid with the Defendants and I should be candid with Plaintiffs. Can that argument really apply in the context of 501(C)(3) organization at all?

Wouldn't that defeat unrelated business—I can't remember the name of that—

MR. GREGORY: UBTI.

THE COURT:—UBTI in all cases, since after all charitable organizations are always chartered—well, as a condition for getting exemptions they are required to use their funds in only certain limited ways. So they never have free rein with their money.

\* \* \* \* \*

## In the United States Court of Claims

Docket No. 465-82 T

AMERICAN BAR ENDOWMENT, PLAINTIFF,

v.

UNITED STATES OF AMERICA, DEFENDANT.

### JOINT MEMORANDUM RE STIPULATIONS SUBMITTED PURSUANT TO AOG PBT XVI

(Filed: October 6, 1983)

#### PART I

The undersigned parties, by their counsel, hereby stipulate and agree that, for purposes of this action only, the following facts shall be taken as true, subject to the right of either party to introduce evidence not inconsistent with any of these stipulated facts.

1. This is an action arising under the Internal Revenue laws of the United States and is brought pursuant to Section 1491 of Title 28 of the United States Code, as amended. This Court has jurisdiction over this action.

2. This action is brought by the American Bar Endowment ("Endowment") for the recovery of the following amounts of unrelated business income tax and assessed interest thereon collected from the Endowment for its fiscal years ended June 30, 1979, 1980 and 1981, together with statutory interest thereon as provided by law.

<u>Year</u>	<u>Tax</u>	<u>Assessed Interest</u>	<u>Total</u>
1979	\$1,587,924.000	\$427,845.18	\$2,015,769.18
1980	2,326,774.00	376,363.66	2,703,137.66
1981	2,105,709.00	87,459.04	2,193,168.04
	\$6,020,407.00	\$891,667.88	\$6,912,074.88



3. The Endowment is a charitable membership corporation organized in 1942 under the laws of the State of Illinois with its principal office in Chicago, Illinois. Prior to 1966, its corporate name was the American Bar Association Endowment. Defendant does not dispute that the Endowment is exempt from Federal income taxation under Section 501(a) and 501(c)(3) of the Internal Revenue Code of 1954, Title 26 of the United States Code, as amended ("the Code").

4. All members of the American Bar Association ("ABA"), a professional association exempt from Federal income taxation under Sections 501(a) and 501(c)(6) of the Code, are, by virtue of their membership in the ABA, members of the Endowment. Members pay no additional dues for membership privileges in the Endowment.

5. The Endowment was organized for one or more exempt purposes within the meaning of Treasury Regulation Section 1.501(c)(3)-1(b).

6. The Endowment has to date made grants of approximately \$63 million for charitable work in the field of law.

7. In its fiscal years 1979, 1980 and 1981, the Endowment awarded grants in the following amounts:

<i>Year</i>	<i>Grants Awarded</i>
1979	\$3,602,462
1980	4,397,619
1981	4,640,000

8. The recipients of the above-referenced grants were the American Bar Foundation, the ABA Fund for Public Education, the Institute of Judicial Administration, the Institute for Court Management, the National College of District Attorneys, The National Council of Juvenile and Family Court Judges, the National College of Criminal Defense Lawyers, the National Institute for Trial Advocacy, and the National Legal Aid and Defender Association.

9. The Endowment has three sources of funds, namely, individual gifts and bequests, investment of cash reserves, and dividends to policyholders and experience credits (also known as retrospective rate refunds or premium refunds). Most of the funds of the Endowment are attributable to the dividends and experience credits.

10. In the early 1950's, leaders of the ABA conceived the idea that providing group life insurance coverage for ABA members could be a means of obtaining funds for the Endowment to further its charitable and educational activities in the field of law.

11. In the early and mid-1950's, William Clarke Mason was the chairman of the Special Committee on Group Life Insurance of the ABA. Mr. Mason spoke with certain insurance companies concerning the idea of a group insurance program as a charitable fund raising tool.

21. At the time that Mr. Mason was speaking with insurance companies in the 1950's, the concept of underwriting a voluntary association for group life insurance was a novel one. At least one of the insurance companies he spoke to, Prudential, was not interested in underwriting an association group.

13. In late 1953, Mr. Mason, representing the American Bar Association, came to New York to meet with several representatives of New York Life Insurance Company, including Joseph W. Moran. The purpose of the meeting was to explore the feasibility of developing a group life insurance plan for members of the American Bar Association to generate funds for charitable and educational purposes in the field of law.

14. After several months of discussion with Mr. Mason, New York Life Insurance Company designed a group insurance program that was offered to the ABA on condition that a minimum number of members enroll. Attached hereto as Exhibit 300 is a true and correct copy of

the Specifications for Group Insurance, dated February 20, 1955 and signed by Mr. Mason. Exhibit 300 may be admitted into evidence.

15. By resolution dated February 19, 1955, the Board of Governors of the American Bar Association requested the Endowment to become the policyholder of the proposed contract with New York Life Insurance Company. This request was presented to the Board of Directors of the Endowment on February 20, 1955. At that meeting, William Clarke Mason presented the proposed contract between the Endowment and New York Life Insurance Company. The Board of Directors of the Endowment authorized the appropriate officer of the Endowment to enter into the contract on behalf of the Endowment. Attached hereto as Exhibit 305 is a true and correct copy of the minutes of the special meeting of the Board of Directors of the Endowment held on February 20, 1955. Exhibit 305 may be admitted into evidence.

16. The contract between the American Bar Endowment and New York Life Insurance Company became effective on June 1, 1955, a sufficient number of Endowment members having enrolled in the program to satisfy New York Life Insurance Company. Attached hereto as Exhibit 306 is a true and correct copy of the minutes of the annual meeting of directors of the Endowment held on August 20, 1955. Exhibit 306 may be admitted into evidence.

17. On June 9, 1955, Mr. Mason wrote the presidents of the American Bar Association and the American Bar Association Endowment summarizing the status of the life insurance program. Attached as Exhibit 268 is a true and correct copy of Mr. Mason's letter. Exhibit 268 may be admitted into evidence.

18. On August 22, 1955, the president of the Endowment reported to the members that the contract had gone into effect between New York Life Insurance Company

and the Endowment and that the Endowment expected that the American Bar Foundation would receive the proceeds of some of the life insurance policies and that the Endowment would receive the dividends from the insurance plan. President Carl B. Rix told the members that the Endowment would reimburse itself for its expenses out of the dividends and expected that funds would be available for the operation and maintenance of the William Nelson Cromwell Library, operated by the American Bar Foundation. Attached hereto as Exhibit 307 is a true and correct copy of the minutes of the annual meeting of members held on August 22, 1955. Exhibit 307 may be admitted into evidence.

19. The original group life insurance contract entered into by the Endowment is known as the "Junior Plan" because the plan was available only to Endowment members through age 55. This plan insured Endowment members through age 55 without evidence of insurability at a premium of \$20 per year per insured member for a schedule of reducing amounts of term insured that graded from \$6,000 at the youngest age to \$1,000 at age 55. For this reason, the plan was also known as the "\$20 a year plan."

20. From the inception of the program, the Junior Plan has provided that dividends are payable to the Endowment under the following clause:

On each policy anniversary to which the policy has been continued by the payment of all premiums due, the divisible surplus, if any, ascertained and apportioned to this policy as a dividend shall be paid in cash to the Association, or upon its written request may be applied towards the payment of any premium hereon.

This clause, or a substantially similar clause, was in effect on the Endowment's policies with New York Life during the years in issue.



21. In 1956, the Endowment received its first dividend check from New York Life Insurance Company, a check in the amount of \$76,997. It has received a dividend from New York Life each year since then.

22. The initial applications for enrollment provided to Endowment members in 1955 contained the following statement: "I agree that any dividends apportioned to the Group Policy shall be payable to the ABA Endowment." All applications for enrollment in the Endowment's group life insurance program since that time have contained the same or a similar statement.

23. The Endowment's second group life insurance plan (known as the "Senior Plan") was instituted January 1, 1957, and insured Endowment members at ages 50 through 69, subject to evidence of insurability, for a level \$5,000 amount of term insurance at premium [sic] rates which increased with the member's advancing age, with decreasing amounts of insurance continuing beyond age 70.

24. The Senior Plan group policy originally provided in part as follows:

On each policy anniversary to which this policy has been continued by payment of all premiums due, the divisible surplus, if any, shall be ascertained and apportioned to this policy as a dividend. Fifty percent of each dividend shall be applied by New York Life toward payment of the next premium due hereon and the remainder shall be paid in cash to the Association.

25. On April 3, 1958, a rider was entered into (with an effective date of January 1, 1958) modifying the above-quoted clause so that it would be identical to the clause contained in the Junior Plan group policy.

26. On August 28, 1960, riders were entered into (with an effective date of June 1, 1960) providing that the Junior and Senior plans would be treated as a single policy for purposes of ascertaining surplus.

27. Liberalizations of the group life Junior Plan in 1957, 1958, 1963, 1967, and 1971 and of the Senior Plan in 1959, 1960, 1962, 1963, and 1967 included extensions of ages at which Endowment members were insured, increases in the amounts of insurance provided without increases in premiums, addition of double benefits for accidental death without an increase in premiums, reductions in premiums, the addition of options to acquire additional amounts of insurance (subject to evidence of insurability), and the addition of options to enroll for insurance on the lives of spouses and children.

28. In 1971, a new series of group life plans was introduced under which Endowment members below age 72 were insured for amounts of term life insurance ranging from \$20,000 to \$100,000 to age 55, and decreasing amounts from age 55 to age 72, with double benefits for accidental death.

29. Changes were made in the group life program, effective June 1, 1981, by amending the Juniors Plan group policy:

Reduced premiums in Life Schedules B through G, as follows:

Benefit Schedule B (\$30,000)	9.0%
Benefit Schedule C (\$40,000)	13.5%
Benefit Schedule D (\$50,000)	16.2%
Benefit Schedule E (\$75,000)	19.8%
Benefit Schedule F (\$100,000)	21.6%
Benefit Schedule G (\$150,000)	23.4%

Introduced a new Schedule H providing a maximum benefit of \$200,000. Offered to members then insured in Schedules B through G, an opportunity to upgrade their coverage by one or two benefit levels without a statement of health.

Extended a similar nonmedical offer to participants in the Junior, Senior, and Maxi I, II, and III plans.



Extended an offer to members age 55 and over to upgrade their coverage with satisfactory evidence of insurability.

The policy continued to provide for the payment by New York Life of all dividends to the Endowment.

30. As a condition of obtaining coverage under any of the group life insurance policies issued by New York Life Insurance Company during the years in issue, the Endowment required that each individual insured sign an application stating that any dividend apportioned to the policy or policies will be paid to the American Bar Endowment.

31. Attached hereto as Exhibits 275 and 276 are true and correct copies of the Endowment's group term life insurance policies with New York Life Insurance Company (including riders) in effect during the period June 30, 1978, through June 30, 1981.

32. For the Endowment's fiscal year 1978-79, the group life insurance program dividend was 47% of gross premiums. For the Endowment's fiscal year 1979-80, the dividend was 55% percent of gross premiums. For the fiscal year 1980-81, the dividend was 65% of gross premiums.

33. Effective November 1, 1961, the Endowment entered into a contract with the Continental Casualty Company to provide disability income coverage for Endowment members (known as the DID program. In-hospital indemnity coverage (known as "ESP"-Essential Supplementary Protection) through Continental Casualty was added in 1965.

34. The DID program consists of two plans—Plan I, which has a 30-day elimination period and Plan II, which has a 365-day elimination period.

35. In 1969, the Endowment transferred both the disability and ESP programs from Continental Casualty Company to Mutual of Omaha Insurance Company which has underwritten them ever since.

36. Effective November 1, 1969, premiums for Plan I of the DID insurance program were reduced by 10 percent or approximately 10 percent at all ages, and premiums for Plan II of the DID insurance program were reduced by 15 percent or approximately 15 percent at all ages.

37. For the Endowment's fiscal year 1978-79, the experience credits on the disability and ESP programs were 38 and 48 percent of gross premiums respectively. For the Endowment's fiscal year 1979-80, the experience credits on the disability and ESP programs were 54 and 39 percent of gross premiums respectively. For the Endowment's fiscal year 1980-81, the experience credits were 34 and 45 percent of gross premiums respectively.

38. The Endowment and Mutual of Omaha entered into a Contingency Fund Escrow Account Agreement effective December 3, 1970. True and correct copies of this agreement, an addendum listing the securities held in escrow account, and the acknowledgement and receipt by the administrator of the escrow account are attached as Exhibit 3400.

39. Effective May 1, 1971, premiums for Plan I of the DID insurance program were reduced by 10 percent or approximately 10 percent at all ages.

40. Effective May 1, 1974, benefits were increased for the DID insurance program.

41. Effective May 1, 1980, the maximum benefit levels offered under the DID insurance program were changed by adding a \$2,000 monthly benefit and a \$2,500 monthly benefit available to eligible members at certain ages.

42. Attached hereto as Exhibit 277 is a true and correct copy of the Endowment's group insurance disability policy with Mutual of Omaha (including riders) in effect during the period June 30, 1978, through June 30, 1981.

43. In 1970, the following changes were made to the ESP program (effective May 1, 1970):

A new schedule of daily in-hospital benefit of \$40 per day for ages 65 and under and \$25 a day for ages over 65 was offered to both new and existing insureds.

The \$20 a day benefit (Schedules A & B) was no longer offered to new members.

A Schedule C offering a \$80 a day benefit was added.

44. Attached hereto as Exhibit 278 is a true and correct copy of the Endowment's group insurance in-hospital policy with Mutual of Omaha (including riders) in effect during the period June 30, 1978, through June 30, 1981.

45. In 1973, the Endowment and Mutual of Omaha Insurance Company entered into a contract whereby catastrophic major medical insurance, with a \$10,000 deductible, was provided to Endowment members and their dependents. When the program was first underwritten, the experience on it was good and experience credits were 44%, 65%, 69%, 40% and 37% of the respective gross premiums for the Endowment's fiscal years 1974, 1975, 1976, 1977 and 1978. In the last four years, however, inflation in health care costs, including increased availability and use of expensive new technology, has adversely affected the program. Rates have been raised four times in the past four years. For the Endowment's fiscal years 1979, 1980 and 1981, the experience credits on this program were 2.2%, 10.2% and 20.3% of gross premiums respectively.

46. The Endowment and Mutual of Omaha entered into a Contingency Fund Escrow Account Agreement, effective June 8, 1974, whereby the Endowment agreed to create a Contingency Fund Escrow Account on the major medical policy to meet Mutual of Omaha's requirements. True and correct copies of this agreement, an addendum listing securities held in escrow account, and the acknowledgement and receipt by the escrow account administrator are attached as Exhibit 3401.

47. Effective September 1, 1979, rates were increased in the major medical program by 40 percent for members and spouses and by 100 percent for children.

48. Effective September 1, 1980, the following changes were made to the major medical program:

A new \$15,000 deductible plan was offered at the same rate as the \$10,000 deductible plan.

At the same time, rates for the \$10,000 deductible plan were increased by 25 percent for new enrollees.

Rates for the \$10,000 deductible plan for existing enrollees were increased by 25 percent effective March 1, 1981.

49. Effective September 1, 1982, rates were increased by 30 percent in the major medical program, except for members aged 65 and over.

50. Attached hereto as Exhibit 280 is a true and correct copy of the Endowment's group major medical insurance policy with Mutual of Omaha (including riders) in effect during the period June 30, 1978, through June 30, 1981.

51. Effective November, 1971, Mutual of Omaha and the Endowment entered into a contract whereby accidental death and dismemberment (ADD 250) coverage up to \$250,000 was provided to Endowment members. ADD 250 provides both an individual and a family plan. Enrollment was not as great as expected and claims experience was unexpectedly adverse for the first few years of the program resulting in no experience credits for the Endowment's fiscal years 1977 and 1978. For the Endowment's fiscal years 1979, 1980 and 1981, the experience credits were 0%, 52%, and 0% of gross premiums respectively.

52. The Endowment and Mutual of Omaha entered into a Contingency Deposit Escrow Account Agreement, effective November 1, 1976, for the ADD 250 program. True and correct copies of this agreement, the addendum



listing securities to be held (labeled American Bar Endowment), and the acknowledgement and receipt of securities by the administrator of the escrow account are attached as Exhibit 3402.

53. Attached hereto as Exhibit 279 is a true and correct copy of the Endowment's group ADD/250 program with Mutual of Omaha (including riders) in effect during the period June 30, 1978, through June 30, 1981.

54. Under the terms of the group insurance contracts between the Endowment and Mutual of Omaha, retrospective rate credits are payable to the Endowment.

55. The applications for enrollment for all the group insurance policies issued by Mutual of Omaha during the years in issue contained the following statement: "I understand and agree . . . that any experience credits apportioned to the Group Policy shall be payable to the American Bar Endowment and are contributions from the participants."

56. The Endowment is the group policyholder for each of its insurance programs.

57. Each Endowment member who enrolls in an insurance program makes a payment of his or her portion of the premium to the Endowment which in turn pays the total gross premium for the insurance program to the appropriate insurance company.

58. In its fiscal years 1979, 1980 and 1981, the Endowment paid the following aggregate amounts of gross premiums and received the following aggregate amounts of dividends and experience credits from New York Life and Mutual of Omaha:

Year	Gross Premiums	Dividends/Experience Credits
1979	\$12,786,240	\$5,132,662
1980	13,689,726	6,758,341
1981	14,107,634	6,860,190

59. In the years in issue in this litigation as well as in preceding years back to 1964, after receipt of dividends and experience credits from New York Life and Mutual of

Omaha (or Continental Casualty) the Endowment mailed a notice informing each insured member of the percentage of his or her payment toward gross premium for the prior year that the Endowment contended constituted the member's charitable contribution to the Endowment. True and correct copies of such notices are attached hereto as Exhibits 189 through 224. Exhibits 189 through 224 may be admitted into evidence.

60. In determining the percentages for each year that the Endowment contends constituted charitable contributions, the Endowment deducted its expenses of operation allocable to the administration of its insurance programs from the dividends and experience credits received from New York Life and Mutual of Omaha. The Endowment does not contend that it deducted from dividends and experience credits during its fiscal years 1979, 1980 and 1981 expenses not allocable to its group insurance programs.

61. During its fiscal years 1979, 1980 and 1981, the Endowment had insurance contracts only with New York Life and Mutual of Omaha, both of which are insurance companies licensed to do business in the State of Illinois.

62. During its fiscal years 1979, 1980 and 1981, there was a licensed insurance broker for the Endowment insurance program whose compensation was paid on a commission basis by New York Life and Mutual of Omaha.

63. The Commissioner of Internal Revenue caused the Endowment's returns for its fiscal years 1979, 1980 and 1981 to be audited and, as a result of such audits, determined against the Endowment unrelated business income tax deficiencies for such years which were paid to the Internal Revenue Service by the Endowment as follows:

Year	Principal Payment	Date Paid	Interest Payment	Date Paid
1979	\$1,587,000	3/2/82	\$427,845.15	11/2/82
	924	7/8/82		
1980	2,326,774	3/2/82	376,363.66	7/8/82
1981	2,105,709	3/2/82	—	—



64. On December 30, 1982, the Endowment, which previously had paid \$2,105,709.00 in unrelated business income tax for its 1981 fiscal year to the Internal Revenue Service, paid \$87,459.04 in interest on that payment. Such amount of interest was computed based on the \$2,105,709 in unrelated business income tax for the Endowment's 1981 fiscal year paid to, and subsequently assessed by, the Internal Revenue Service.

65. Attached hereto as Exhibit 367, Exhibit 311 and Exhibit 368 are true and correct copies of the revenue agent's reports for the Endowment's fiscal years 1979, 1980 and 1981.

66. On July 15, 1982, the Endowment filed with the Director of the Regional Service Center in Kansas City, Missouri, Claims for Refund, consisting of Forms 990-T accompanied by a statement of facts and grounds upon which the refund of tax paid for each of its fiscal years 1979, 1980, and 1981, and the refund of interest paid for its fiscal year 1980, was sought. On December 30, 1982, the Endowment filed with the Director of the Regional Service Center in Kansas City, Missouri, Claims for Refund of interest, consisting of amended Forms 990-T accompanied by a statement of facts and grounds upon which the refund of interest paid for its fiscal years 1979 and 1981 was sought. All such claims were filed within the time prescribed by law and set forth the grounds upon which this suit is brought.

67. On August 6, 1982, the Commissioner mailed by certified mail a notice of disallowance in full of the Claims for Refund filed on July 15, 1982. Six months have passed without final action by the Internal Revenue Service on the Claims for Refund filed on December 30, 1982. This suit is brought within the time prescribed by law.

68. Although repayment thereof has been demanded, no part of the sum of \$6,912,074.88 has been credited, remitted, refunded, or repaid to the Endowment or to anyone on its account.

69. Attached hereto as Exhibits 281, 282, 1109, and 283 are copies of Financial Reports forwarded by New York Life Insurance Company to the Endowment for life insurance policy years ending May 31, 1978, May 31, 1979, May 31, 1980 and May 31, 1981 respectively. Exhibits 281, 282, 1109 and 283 may be admitted into evidence.

70. Attached hereto as Exhibits 284, 285, 286 and 287 are copies of Disability and E.S.P. Experience and Claim study reports forwarded by Mutual of Omaha Insurance Company to the Endowment for policy years ending October 31, 1972, October 31, 1973, October 31, 1974, October 31, 1975, October 31, 1976, October 31, 1977, October 31, 1978, October 31, 1979, October 31, 1980 and October 31, 1981 inclusive. Exhibits 284, 285, 286, and 287 may be admitted into evidence.

71. Attached hereto as Exhibits 289, 290, 291, and 292 are copies of Major Medical Experience and Claim Study reports forwarded by Mutual of Omaha to the Endowment for policy years ending February 28, 1978, February 28, 1979, February 29, 1980 and February 28, 1981 inclusive. Exhibits 289, 290, 291, and 292 may be admitted into evidence.

72. Attached hereto as Exhibits 293, 294, 295, and 296 are copies of ADD/250 Program Experience and Claim Reports forwarded by Mutual of Omaha to the Endowment for policy years ending July 31, 1978, July 31, 1979, July 31, 1980 and July 31, 1981 respectively. Exhibits 293, 294, 295 and 296 may be admitted into evidence.

73. This Court has jurisdiction over the cases of *Turner v. United States*, No. 163-83T, *Sherwood v. United States*, No. 190-83T, *Boynton v. United States*, No. 320-83T and *Broadfoot v. United States*, No. 351-83T.

74. Most lawyers have life insurance.

75. Most lawyers have accident and/or health insurance.

76. The dividends and experience credits received by the Endowment would not exist but for the payments toward premium by insured members in the year before the receipt by the Endowment of dividends or experience credits being greater than the losses incurred and retention due to the insurance carriers in the year to which the dividends or experience credits relate.

77. Attached hereto as Exhibits 178 and 179 are true and correct copies of the Endowment's exempt organization business income tax returns for the fiscal year beginning July 1, 1978 and ending June 30, 1979, as originally filed and as amended, with attached "Explanation of Claim for Refund." Exhibits 179 and 178 may be admitted into evidence.

78. Attached hereto as Exhibit 180 is a true and correct copy of the Endowment's exempt organization business income tax return for the fiscal year beginning July 1, 1979 and ending June 30, 1980, with attached "Explanation of Claim for Refund." Exhibit 180 may be admitted into evidence.

79. Attached hereto as Exhibits 177 and 181 are true and correct copies of the Endowment's exempt organization business income tax returns for the year beginning July 1, 1980 and ending June 30, 1981, as originally filed and as amended, with attached "Explanation of Claim for Refund." Exhibits 177 and 181 may be admitted into evidence.

80. Attached hereto as Exhibit 267 is a true and correct copy of the American Bar Endowment's Articles of Incorporation and By-laws in effect during the years in issue in this litigation. Exhibit 267 may be admitted into evidence. Attached hereto as Exhibit 3403 is a true and correct copy of the American Bar Endowment's original Articles of Incorporation and By-Laws. Exhibit 3403 may be admitted into evidence.

81. Attached hereto as Exhibits 784, 312, 785 through 787, and 313 through 316 are true and correct copies of the annual reports of the Endowment distributed to all Endowment members for its years ended 1973 to 1981, respectively. Exhibits 784, 312, 785 through 787 and 313 through 316 may be admitted into evidence.

82. During the years in issue in this litigation, each of the Endowment's directors was a volunteer member of the Endowment who was reimbursed only for out of pocket expenses. No director received monetary or other compensation for the substantial expenditure of time attributable to carrying out the duties of a director. -

83. Participation in the Endowment's group insurance programs has always been voluntary.

84. During the years in issue in this litigation, less than 25% of the members of the ABA participated in one or more of the Endowment's insurance programs.

85. Prior to and during the Endowment's fiscal years 1979, 1980 and 1981, the American Bar Association did not establish group insurance programs for its members.

86. The Endowment received a proposal from James Group Service, Inc., in 1981 to administer the Endowment's group insurance programs for a fee of about \$1,000,000 per year. Attached hereto as Exhibits 737 and 329 are true and accurate copies of James Group Service, Inc.'s proposal and the specifications for that proposal prepared by James Group Service, Inc. Exhibits 737 and 329 may be admitted into evidence.

87. New York, Nebraska, and Illinois law prohibit anyone other than a licensed agent or broker from being the agent or broker of record and anyone but the agent or broker of record from receiving a broker's or agent's commission. The Endowment is not and never has been the agent or broker of record with respect to its group insurance programs.



88. The American Bar Association maintains a list of the names and addresses of its entire membership.

89. The American Bar Association rents its membership list to commercial organizations for a commercially competitive fee. During the years in issue, the American Bar Association charged commercial organizations a basic fee of \$35.00 or \$40.00 per thousand names. Attached hereto as Exhibits 1209 and 1210 are the price lists of the American Bar Association dated May, 1978 and July, 1980. Exhibits 1209 and 1210 may be admitted in evidence.

90. The American Bar Association does not require the Endowment to rent its membership list. Rather, the Endowment pays only for the cost of the ABA's data processing service and the production of labels. The Endowment does not pay the ABA a commercially competitive fee for use of the membership list.

91. The charge by the ABA for data processing service and mailing labels to the Endowment varied from \$8.00 per thousand names to \$8.75 per thousand names during the years in issue in this litigation.

92. The Endowment operates on a July 1-June 30 fiscal year and uses the accrual basis of accounting.

93. Attached hereto as Exhibits 3408, 3409, 3410, 3411, 3412, 3413, 3414, 1864, 1863, 1861, and 3415 are true and correct copies of the Audited Financial Statements and Other Financial Information for the Endowment's fiscal years ended June 30, 1972, 1973, 1974, 1975, 1976, 1977, 1978, 1979 and 1980 and the Audited Financial Statements and Supplementary Information for the Endowment's fiscal year ended June 30, 1981 and 1982. Exhibits 3408, 3409, 3410, 3411, 3412, 3413, 3414, 1864, 1863, 1861, and 3415 may be admitted into evidence.

94. During its fiscal years ended June 30, 1979, 1980, and 1981, the Endowment accrued the following amounts as dividends and experience credits from the respective insurance carriers (New York Life and Mutual of Omaha):

	<u>1979</u>	<u>1980</u>	<u>1981</u>
Dividend on life insurance program for policy years ended May 31, 1979, 1980, and 1981	\$3,466,830	\$4,266,309	\$4,981,412
Experience credit on disability insurance program for policy years ended October 31, 1978, 1979, and 1980	1,092,975	1,563,802	1,101,491
Experience credit on in-hospital indemnity program for policy years ended October 31, 1978, 1979, and 1980	555,463	462,481	527,718
Experience credit on major medical program for policy years ended February 28, 1979, 1980, and 1981	17,394	117,658	249,569
Experience credit on accidental death and dismemberment program for policy years ended July 31, 1978, 1979, and 1980	-0-	348,091	-0-

95. During the years in issue in this litigation, the Endowment allocated its operating expenses (costs) among its eight activities—the life insurance program, the disability income insurance program, the in-hospital indemnity insurance program, the major medical insurance program, the accidental death and dismemberment insurance program, grants, investments, and the Memorial Fund. Taking all five insurance programs into account, the expenses were so allocated by use of a [sic] allocation system which, based on regularly maintained activity records of the Endowment, reasonably matched the Endowment's expenses to the activities and Endowment department that generated them. Attached hereto as Exhibit 229 is a true and correct copy of a report by Peter P. Kezon, Jr., dated January 11, 1980, which summarizes the Endowment's cost allocation system. Exhibit 229 may be admitted into evidence.

96. The cost allocation system used by the Endowment to allocate its operating expenses among its eight activities during the years in issue in this litigation has been used consistently by the Endowment since and during its fiscal year ended June 30, 1977.



97. By application of the cost allocation system, the Endowment allocated its operating expenses for its fiscal years ended June 30, 1979, 1980, and 1981 among its eight activities as follows:

	<u>1979</u>	<u>1980</u>	<u>1981</u>
Life insurance program	\$483,410	\$431,189	\$744,473
Disability income insurance program	265,876	280,275	277,259
In-hospital indemnity insurance program	198,671	254,441	210,149
Major medical insurance program	303,016	137,364	467,587
Accidental death and dismemberment insurance program	228,316	222,926	212,534
Grants	1,091	834	1,365
Investments	84,949	101,541	110,068
Memorial Fund	2,058	1,059	-0-

Taking all five insurance programs into account, such allocations appropriately reflected Endowment's costs in such fiscal years. If the Court's judgment is for less than the amount prayed for by plaintiff but more than zero, defendant contends that the proper allocation of income and expenses will require a recomputation in accordance with the Court's opinion.

98. Attached hereto as Exhibit 225 is a true and correct copy of a letter dated December 12, 1979 to Richard S. Breiner, Administrator of the Endowment, from Ernst & Whinney which sets forth Ernst & Whinney's computations of the percentage of insurance premium collections from insured members for the Endowment's fiscal year ended June 30, 1979 and policy years ended within that fiscal year which the Endowment treated as charitable contributions from its insured members. Exhibit 225 may be admitted into evidence.

99. Attached hereto as Exhibit 226 is a true and correct copy of a letter dated December 2, 1980 to Richard S. Breiner, Administrator of the Endowment, from Ernst & Whinney which sets forth Ernst & Whinney's computation of the percentage of insurance premium collections from insured members for the Endowment's fiscal year ended June 30, 1980 and policy years ended within that fiscal

year which the Endowment treated as charitable contributions from its insured members. Exhibit 226 may be admitted into evidence.

100. Attached hereto as Exhibit 227 is a true and correct copy of a letter dated November 9, 1981 to Richard S. Breiner, Administrator of the Endowment, from Arthur Young & Company which sets forth Arthur Young & Company's review of the Endowment's computation of the percentage of insurance premium collections from insured members for the Endowment's fiscal year ended June 30, 1981 and policy years ended within that fiscal year which the Endowment treated as charitable contributions from its insured members. Exhibit 227 may be admitted into evidence.

101. The Endowment vigorously pursues enrollment of new members and members who have not enrolled in the insurance program and it seeks to induce those members already enrolled to increase their coverage.

102. The Endowment's solicitation efforts were made primarily through the mail and through answering telephone inquiries concerning the program.

103. The Endowment distributes to its members brochures, rate schedules, and applications, all bearing its name. Its correspondence endorses the group insurance.

104. The tasks undertaken by plaintiff in administering the group insurance programs during the years in issue in this litigation included processing of enrollment applications to some extent; disbursing certificates of coverage to members; billing, collecting, and accounting for premiums due from individuals insured; forwarding premiums to the applicable insurance company; disbursing premium refunds to individuals [sic] insured members who cancel coverage or pay an incorrect premium; and checking claims for completeness prior to processing by the insurance company which consists of verifying the status of members and checking to see if the proper premium has been paid and that the insurance benefits are in effect.

105. Approximately 75 percent of the applicants for insurance through the Endowment's group insurance program are approved by the Endowment by means of "screen rules" set up the the [sic] insurance companies.

106. Exhibit 8 of Appendix B to the brief for the United States in support of its motion for summary judgment, filed February 23, 1983 is a true and correct copy of New York Life Insurance Company procedures and underwriting rules for American Bar Endowment dated March 3, 1975.

107. The insurance programs are administered by the Endowment staff (which fluctuated from approximately 34 to 44 people during the years in issue in this litigation) under the direction of an administrator.

108. Attached hereto as Exhibit 3404 is a true and correct copy of the *1966 Report of the American Bar Endowment* which appeared in Volume 52 of the American Bar Association Journal (1966). Exhibit 3404 may be admitted into evidence.

109. Exhibit 18 of Appendix B to the brief for the United States in support of its motion for summary judgment, dated February 23, 1983, accurately sets forth the names and departments of employees who accrued vacation during the fourth quarter of fiscal year 1981.

110. Exhibit 19 of Appendix B to the brief for the United States in support of its motion for summary judgment, filed February 23, 1983, contains accounting procedures for the Endowment for fiscal year 1981.

111. Attached hereto as Exhibit 3405 is a true and correct copy of an article by Harold J. Gallagher, then a director of the Endowment, entitled *Group Life Insurance Plan for Members of the American Bar Association*. That article appeared in Volume 41 of the American Bar Association Journal (1955). Exhibit 3405 may be admitted into evidence.

112. Attached hereto as Exhibit 3406 is a true and correct copy of an article entitled *Endowment Insurance Offers Expanded Benefits* which appeared in Volume 44 of the American Bar Association Journal (1958). Exhibit 3406 may be admitted into evidence.

113. Attached hereto as Exhibit 3407 is a true and correct copy of the *1962 Annual Report to Members of American Bar Association Endowment*, which appeared in Volume 48 of the American Bar Association Journal (1962). Exhibit 3407 may be admitted into evidence.

114. During its fiscal year 1980, more than 57,000 of the Endowment's total membership participated in its group insurance program (either by renewal or first-time participants). The number of insurance certificates outstanding in all of the programs by the Endowment was 111,260. The Life Insurance Plan, underwritten by New York Life Insurance Company, had \$2.75 billion of insurance in force, representing almost a three-fold increase over the amount of insurance in force in 1974.

115. Attached hereto as Exhibits 842, 847, 858, 859, 862, 863, 971, 882, 883 and 888 are true and accurate copies, respectively, of "Nineteen Seventy-seven, Seventy-eight Add/250 Promotion Summary"; "Nineteen Seventy-seven, Seventy-eight Major Medical Promotion Summary"; "Life Promotion Summary 1979"; "Add/250 Promotion Summary 1978-79"; "Summary of Promotions 1978-79"; "Add/250 Promotion Summary 1979-80"; "DID Promotion Summary 1979-80"; "ESP Promotion 1979-80"; "Summary of Promotions 1979-80, etc."; and "The Life Promotion." Exhibits 842, 847, 858, 859, 862, 863, 871, 882, 883, and 888 are copies of documents found in the files of the Endowment and may be admitted into evidence.

116. Attached hereto as Exhibit 582 is a true and correct copy of a letter dated June 2, 1978, from Richard S. Breiner to Kenneth Liles. Exhibit 582 may be admitted into evidence.



117. The Endowment will not contend at trial that it did not regularly carry on the activities associated with its role as group policyholder.

118. The Endowment will not contend at trial that the activities associated with its role as group policyholder are substantially related to its tax-exempt purpose within the meaning of IRC § 513(a).

119. Attached hereto as Exhibit 627 is a true and accurate copy of a report dated 10/10/80, with exhibits, prepared by Joseph W. Moran, New York Life. Exhibit 627 may be admitted into evidence.

120. Attached hereto as Exhibits 2044-2053 and 2070-2091 are true and correct copies of documents contained in the Endowment's files concerning State Bar of California, New Jersey St. Bar Assn., St. Bar of Georgia, Conn. Bar Assn., Colo. Bar Assn., Arkansas Bar Assn., Alaska Bar Assn., Alabama Bar Assn., State Bar of Texas, Kentucky Bar Assn., Iowa St. Bar Assn., Indiana State Bar, Miss. State Bar, Minn. State Bar, State Bar of Michigan, Mass Bar Assn., Maryland St. Bar Assn., Maine St. Bar Assn., Louisiana St. Bar Assn., Ohio St. Bar Assn., NY State Bar Assn., N Carolina Bar Assn., Nebraska St. Bar Assn., Detroit Bar Assn., Virginia State Bar, St. Louis Bar Assn., St. Bar of S. Dak., S. Carolina Bar, Oklahoma Bar Assn., Essex Co. Bar Assn. LA County Bar Assn. and Phil. Bar Assn.

## **In the United States Court of Claims**

Docket No. 163-83 T

FREDERICK D. TURNER AND MARGARET S. TURNER,  
PLAINTIFFS,

v.

UNITED STATES OF AMERICA, DEFENDANT

**JOINT MEMORANDUM RE STIPULATIONS  
SUBMITTED PURSUANT TO AOGPBT ¶VI**

(Filed: October 6, 1983)

### **PART I**

The undersigned parties, by their counsel, hereby stipulate and agree that, for purposes of this action only, the following facts shall be taken as true, subject to the right of either party to introduce evidence not inconsistent with any of these stipulated facts.

1. This is a suit for refund of \$25 in tax, plus statutory interest, for the tax year ended December 31, 1980.

2. Plaintiff\* is a member of the American Bar Association, a professional membership association for lawyers. The Association has been found by the Internal Revenue Service to be exempt from federal income taxation under Sections 501(a) and 501(c)(6) of the Internal Revenue Code. Plaintiff is also a member of the American

\* For clarity in this stipulation, "plaintiff" will refer to Frederick D. Turner and "plaintiffs" will refer to Frederick D. Turner and Margaret S. Turner.



Bar Endowment, by reason of his membership in the American Bar Association. The Endowment is an educational and charitable membership association which also has been found by the Internal Revenue Service to be exempt from federal income taxation under Sections 501(a) and 501(c)(3) of the Internal Revenue Code. The Endowment's by-laws provide that all members in good standing in the American Bar Association are members of the Endowment.

3. Since the mid-1950's, the Endowment has sponsored a group insurance program for its members as a means of obtaining additional funds for its charitable purposes in the field of law.

4. During the taxable year involved, and since the insurance program was first initiated, the Endowment was the group policyholder of group life insurance policies underwritten by New York Life Insurance Company. This group insurance was available to all Endowment members who were eligible to enroll in the life insurance program.

5. Pursuant to the terms of these policies, dividends were paid to the policyholder (*i.e.*, the Endowment) by the New York Life Insurance Company. The group policies with New York Life Insurance company expressly provided as follows until June 1, 1981:

On each policy anniversary to which this policy has been continued by payment of all premiums due, the divisible surplus, if any, ascertained and apportioned to this policy as a dividend shall be paid in cash to the Association, or upon its written request may be applied towards the payment of any premiums hereon.

6. As a condition to enrolling in the group life insurance program, the Endowment has required that each individual insured sign an application stating that any dividends apportioned to the policy or policies will be paid to the American Bar Endowment.

7. The Endowment contends that the dividends, after deduction of allocable expenses, are received from the members as charitable contributions. In this regard, the Endowment mails a notice to each individual insured every year, informing the member of the percentage of his or her gross premium payment for the prior year that the Endowment alleges constitutes a charitable contribution. In determining the percentage that constituted the alleged charitable contribution, the Endowment deducts its expenses allocable to the administration of its life insurance program.

8. Effective December 1, 1972, plaintiff enrolled for \$20,000 of life insurance coverage under the Endowment's group life insurance program underwritten by New York Life Insurance Company. When plaintiff enrolled for coverage under the group life insurance program, he reviewed Endowment literature and signed a statement on the application form agreeing and acknowledging that any dividends apportioned to the life insurance program by New York Life would be paid to the Endowment.

9. Since enrolling in the group insurance program, plaintiff has paid the applicable gross premium each year. During the period in dispute, plaintiff paid semiannual premiums of \$50 on November 15, 1978, May 27, 1979, December 1, 1979, May 5, 1980, November 4, 1980, and May 20, 1981.

10. A booklet entitled *Group Insurance Program, Time to Get Aboard*, summarizing the principal provisions of the group insurance benefits, which was received by plaintiff and reviewed by him before he entered into the group insurance program in 1972, stated, *inter alia*, that —

The Program offers eligible Endowment members attractive insurance benefits for a reasonable annual cost.

A true and correct copy of this booklet is attached hereto as Exhibit 376. In 1979, dependent spouse and child coverage offered through the Endowment was increased. The Endowment also advertised a special 45-day period wherein uninsured members under age 50 could obtain \$20,000 of coverage without medical evidence of insurability. In 1981, New York Life reduced premium rates on certain parts of the Endowment plan and increased maximum life insurance benefits.

11. In 1980, plaintiff received a written notice from the Endowment, which had received a dividend from New York Life, advising that, in the opinion of the Endowment's auditors and counsel, each insured member had in 1980 made a contribution of 49.3 percent of any life insurance premiums paid in the period from December 1, 1978, through November 30, 1979. The Endowment further advised in the notice that the Internal Revenue Service had ruled that members were not entitled to charitable contribution deductions for any portion of their premium payments.

12. Plaintiffs, in filing their joint federal income tax return for 1980, did not claim a deduction for any portion of the gross insurance premium paid to American Bar Endowment. Plaintiffs subsequently filed a claim for refund, contending that they were entitled to an additional charitable contribution of \$49 relating to the gross premium payment made to the American Bar Endowment. The instant suit followed.

13. Attached as Exhibit No. 8005 are the answers of plaintiff Frederick D. Turner to defendant's first set of interrogatories.

14. Attached as Exhibit No. 8006 are the answers of plaintiff to defendant's second set of interrogatories.

15. Attached as Exhibit No. 8007 is the response of plaintiff to defendant's first request for production of documents.

## PART II

Neither party proposed any stipulations in *Turner v. United States* which they wish to address in this part of the Memorandum Re Stipulations.

Dated: October 5, 1983

Respectfully submitted,

The United States

Frederick D. Turner and  
Margaret S. Turner

By /s/ B. JOHN WILLIAMS, JR. By /s/ FRANCIS M. GREGORY, JR.

B. John Williams, Jr.  
Acting Assistant  
Attorney General

Francis M. Gregory, Jr.

# In the United States Court of Claims

Docket No. 190-83 T

ARTHUR M. SHERWOOD AND KAREN H. SHERWOOD,  
PLAINTIFFS,

v.

UNITED STATES OF AMERICA, DEFENDANT

JOINT MEMORANDUM RE STIPULATIONS  
SUBMITTED PURSUANT TO AOGPBT XVI

(Filed: October 6, 1983)

## PART I

The undersigned parties, by their counsel, hereby stipulate and agree that, for the purposes of this action only, the following facts shall be taken as true, subject to the right of either party to introduce evidence not inconsistent with any of these stipulated facts.

1. This is a suit for refund of \$35.09 in tax, plus statutory interest, for the tax year ended December 31, 1981.

2. Plaintiff\* is a member of the American Bar Association, a professional membership association for lawyers. The Association has been found by the Internal Revenue Service to be exempt from federal income taxation under Section 501(a) and 501(c)(6) of the Internal Revenue Code. Plaintiff is also a member of the American

\* For clarity in this stipulation, "plaintiff" will refer to Arthur M. Sherwood and "plaintiffs" will refer to Arthur M. Sherwood and Karen H. Sherwood.

Bar Endowment, by reason of his membership in the American Bar Association. The Endowment is an educational and charitable membership association which also has been found by the Internal Revenue Service to be exempt from federal income taxation under Sections 501(a) and 501(c)(3) of the Internal Revenue Code. The Endowment's by-laws provide that all members in good standing in the American Bar Association are members of the Endowment.

3. Since the mid-1950's, the Endowment has sponsored a group insurance program for its members as a means of obtaining additional funds for its charitable purposes in the field of law.

4. During the taxable year involved, and since the insurance program was first initiated, the Endowment was the group policyholder of group life insurance policies underwritten by New York Life Insurance Company. This group insurance was available to all Endowment members who were eligible to enroll in the life insurance program.

5. Pursuant to the terms of these policies, dividends were paid to the policyholder (*i.e.*, the Endowment) by the New York Life Insurance Company. The group policies with New York Life Insurance company expressly provided as follows until June 1, 1981:

On each policy anniversary to which this policy has been continued by payment of all premiums due, the divisible surplus, if any, ascertained and apportioned to this policy as a dividend shall be paid in cash to the Association, or upon its written request may be applied towards the payment of any premiums hereon.

6. As a condition to enrolling in the group life insurance program, the Endowment has required that each individual insured sign an application stating that any dividends apportioned to the policy shall be payable to the American Bar Endowment.



7. The Endowment contends that the dividends, after deductions of allocable expenses, are received from the members as charitable contributions. In this regard, the Endowment mails a notice to each individual insured every year, informing the member of the percentage of his or her gross premium payment for the prior year that the Endowment alleges constitutes a charitable contribution. In determining the percentage that constituted the alleged charitable contribution, the Endowment deducts its expenses allocable to the administration of its life insurance program.

8. Effective June 1, 1972, plaintiff enrolled for the Junior Plan under the Endowment's group life insurance program underwritten by New York Life Insurance Company. When plaintiff enrolled for coverage under the group life insurance program, he reviewed Endowment literature and signed a statement on the application form agreeing and acknowledging that any dividends apportioned to the life insurance program by New York Life would be paid to the Endowment. Plaintiff increased his coverage to \$20,000 effective June 1, 1978.

9. Since enrolling in the group insurance program, plaintiff has paid the applicable gross premium each year. During the period in dispute, plaintiff paid semiannual premiums of \$62 on November 27, 1979, May 5, 1980; November 5, 1980; May 7, 1981; and December 21, 1981. In 1979, dependent spouse and child coverage offered through the Endowment was increased. The Endowment also advertised a special 45-day period wherein uninsured members under age 50 could obtain \$20,000 of coverage without medical evidence of insurability. In 1981, New York Life reduced premium rates on certain parts of the Endowment and increased maximum life insurance benefits.

10. In 1981, plaintiff received a written notice from the Endowment, which had received a dividend from New York Life, advising him that, in the opinion of the Endow-

ment's auditors and counsel, each insured member had in 1981 made a contribution to the Endowment of 55.4 percent of any life insurance premiums paid in the period from December 1, 1979, through November 30, 1980. The Endowment further advised in the notice that the Internal Revenue Service had ruled that insured members were not entitled to charitable contribution deductions for any portion of their premium payments.

11. Plaintiffs, in filing their joint federal income tax return for 1981, did not claim a deduction for any portion of the gross insurance premium paid to American Bar Endowment. Plaintiffs subsequently filed a claim for refund, contending that they were entitled to an additional charitable contribution of \$68.70 with respect to dividends to the policyholder paid to the American Bar Endowment. The instant suit followed.

12. Attached as Exhibit No. 8003 are the answers of plaintiff to defendant's first set of interrogatories.

13. Attached as Exhibit No. 8004 are the answers of plaintiff to defendant's second set of interrogatories.

## PART II

Neither party proposed any stipulations in *Sherwood v. United States* which they wish to address in this part of the Memorandum Re Stipulations.

Dated: October 5, 1983

Respectfully submitted,

The United States

Arthur M. Sherwood and  
Karen M. Sherwood

By /s/ B. JOHN WILLIAMS, JR. By /s/ FRANCIS M. GREGORY, JR.

B. John Williams, Jr.

Francis M. Gregory, Jr.

Acting Assistant

Attorney General

# In the United States Court of Claims

Docket No. 320-83 T

FREDERICK G. BOYNTON, PLAINTIFF,

v.

UNITED STATES OF AMERICA, DEFENDANT

JOINT MEMORANDUM RE STIPULATIONS  
SUBMITTED PURSUANT TO AOGPBT ¶VI

(Filed: October 6, 1983)

## PART I

The undersigned parties, by their counsel, hereby stipulate and agree that, for the purposes of this action only, the following facts shall be taken as true, subject to the right of either party to introduce evidence not inconsistent with any of these stipulated facts.

1. This is a suit for refund of \$38 in tax, plus statutory interest, for the tax year ended December 31, 1981.

2. Plaintiff is a member of the American Bar Association, a professional membership association for lawyers. The Association has been found by the Internal Revenue Service to be exempt from federal income taxation under Sections 501(a) and 501(c)(6) of the Internal Revenue Code. Plaintiff is also a member of the American Bar Endowment, by reason of his membership in the American Bar Association. The Endowment is an educational and charitable membership association which also has been found by the Internal Revenue Service to be exempt from federal income taxation under Sections 501(a) and 501(c)(3) of the Internal Revenue Code. The Endowment's by-laws provide that all members in good standing in the American Bar Association are members of the Endowment.

3. Since the mid-1950's, the Endowment has provided a group insurance program to its members as a means of obtaining additional funds.

4. During the taxable year involved, and since 1969, the Endowment has been the group policyholder of a group disability insurance policy underwritten by Mutual of Omaha Insurance Company. This group insurance was available to all Endowment members who were eligible to enroll in the disability insurance program.

5. Pursuant to the terms of this policy, the retrospective rate credits were paid to the policyholder (*i.e.*, the Endowment) by the Mutual of Omaha.

6. As a condition of enrolling in the group disability insurance program, the Endowment has required that each individual insured sign an application stating that any experience credits apportioned to the group policy shall be payable to the Endowment.

7. The Endowment contends that the retrospective rate credits, after deduction of allocable expenses, are received from the members as charitable contributions. In this regard, the Endowment mails a notice to each individual insured every year, informing the member of the percentage of his or her gross premium payment for the prior year that the Endowment alleges constitutes a charitable contribution. In determining the percentage that constituted the alleged charitable contribution, the Endowment deducts the expenses allocable to the administration of its disability insurance program.

8. Effective June 1, 1978, plaintiff enrolled for a \$1,200 monthly disability benefit with a 30-day waiting period under the Endowment's group disability insurance program underwritten by Mutual of Omaha. When plaintiff enrolled for coverage under the group disability insurance program, he reviewed Endowment literature and signed a statement on the application form agreeing that any

retrospective rate credits apportioned to the disability insurance program by Mutual of Omaha would be paid to the Endowment.

9. Since enrolling in the group insurance program, plaintiff has paid the applicable gross premium each year. During the period in dispute, plaintiff paid semiannual premiums of \$90 on (or about) November 1, 1979; May 1, 1980; October 30, 1980; April 21, 1981, and October 29, 1981.

10. In June 1978, the Endowment stated to certain of its members in a letter, attaching a brochure entitled Security Update (Exhibits 840A and 837, true and accurate copies of which are attached hereto) that the DID/ESP programs "can be an important hedge against the constant risk of income loss through disability, and against escalating hospital expenses, with the economy of group rates."

11. Attached hereto as Exhibit 8000 is a true and correct copy of a brochure and attached letter both entitled *Plan Ahead For Protection-Disability Income Dollars (DID)* which was sent by the Endowment to certain insured members.

12. In 1981, plaintiff received a written notice from the Endowment, which had received an experience credit from Mutual of Omaha, advising him that, in the opinion of the Endowment's auditors and counsel, each insured member had in 1981 made a contribution to the Endowment of 28.0 percent of any disability insurance premiums paid in the period from November 1, 1979, through October 30, 1980. The Endowment further advised in the notice that the Internal Revenue Service had ruled that members were not entitled to charitable contribution deductions for any portion of their premium payments.

13. Plaintiff, in filing his federal income tax return for 1981, did not claim a deduction for any portion of the gross insurance premium paid to American Bar Endow-

ment. Plaintiff subsequently filed a claim for refund, contending that he was entitled to an additional charitable contribution of \$50.40 with respect to experience credits paid to the American Bar Endowment. The instant suit followed.

14. Attached as Exhibit No. 8001 are the answers of plaintiff Frederick G. Boynton to defendant's first set of interrogatories.

## PART II

Neither party proposed any stipulations in *Boynton v. United States* which they wish to address in this part of the Memorandum Re Stipulations.

Dated: October 5, 1983

Respectfully submitted,

The United States

Frederick G. Boynton

By /s/ B. JOHN WILLIAMS, JR. By /s/ FRANCIS M. GREGORY, JR.

B. John Williams, Jr.

Francis M. Gregory, Jr.

Acting Assistant

Attorney General



## In the United States Court of Claims

Docket No. 351-83 T

HERBERT C. BROADFOOT, II AND  
NANCY L. BROADFOOT, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

JOINT MEMORANDUM RE STIPULATIONS  
SUBMITTED PURSUANT TO AOGPBT XVI

(Filed: October 6, 1983)

### PART I

The undersigned parties, by their counsel, hereby stipulate and agree that, for the purposes of this action only, the following facts shall be taken as true, subject to the right of either party to introduce evidence not inconsistent with any of these stipulated facts.

1. This is a suit for refund of \$40 in tax, plus statutory interest, for the tax year ended December 31, 1981.

2. Plaintiff\* is a member of the American Bar Association, a professional membership association for lawyers. The Association has been found by the Internal Revenue Service to be exempt from federal income taxation under Sections 501(a) and 501(c)(6) of the Internal Revenue Code. Plaintiff is also a member of the American

\* For clarity in this stipulation, "plaintiff" will refer to Herbert C. Broadfoot and "plaintiffs" will refer to Herbert C. Broadfoot and Nancy L. Broadfoot.

Bar Endowment, by reason of his membership in the American Bar Association. The Endowment is an educational and charitable membership association which also has been found by the Internal Revenue Service to be exempt from federal income taxation under Sections 501(a) and 501(c)(3) of the Internal Revenue Code. The Endowment's by-laws provide that all members in good standing in the American Bar Association are members of the Endowment.

3. Since the mid-1950's, the Endowment has sponsored a group insurance program for its members as a means of obtaining additional funds for its charitable purposes in the field of law.

4. During the taxable year involved, and since the insurance program was first initiated, the Endowment was the group policyholder of group life insurance policies underwritten by New York Life Insurance Company. This group insurance was available to all Endowment members who were eligible to enroll in the life insurance program.

5. Pursuant to the terms of these policies, dividends were paid to the policyholder (*i.e.*, the Endowment) by the New York Life Insurance Company. The group policies with New York Life Insurance company expressly provided as follows until June 1, 1981:

On each policy anniversary to which this policy has been continued by payment of all premiums due, the divisible surplus, if any, ascertained and apportioned to this policy as a dividend shall be paid in cash to the Association, or upon its written request may be applied towards the payment of any premiums hereon.

6. As a condition to enrolling in the group life insurance program, the Endowment has required that each individual insured sign an application stating that any dividends apportioned to the policy or policies will be paid to the American Bar Endowment.

7. The Endowment contends that the dividends, after deduction of allocable expenses, are received from the members as charitable contributions. In this regard, the Endowment mails a notice to each individual insured every year, informing the member of the percentage of his or her gross premium payment for the prior year that the Endowment alleges constitutes a charitable contribution. In determining the percentage that constituted the alleged charitable contribution, the Endowment deducts its expenses allocable to the administration of its life insurance program.

8. Effective December 1, 1972, plaintiff enrolled for \$50,000 of life insurance coverage under the Endowment's group life insurance program underwritten by New York Life Insurance Company. Plaintiff had earlier enrolled for a lesser amount of coverage. When plaintiff enrolled for coverage under the group life insurance program, he reviewed Endowment literature and signed a statement on the application form agreeing and acknowledging that any dividends apportioned to the life insurance program by New York Life would be paid to the Endowment.

9. Since enrolling in the group insurance program, plaintiff has paid the applicable gross premium each year. During the period in dispute, plaintiff paid semiannual premiums of \$98.25 on November 30, 1979, May 27, 1980, and November 28, 1980. Plaintiff paid a semiannual premium of \$83.07 on June 1, 1981 and November 23, 1981. In 1979, dependent spouse and child coverage offered through the Endowment was increased. The Endowment also advertised a special 45-day period wherein uninsured members under age 50 could obtain \$20,000 of coverage without medical evidence of insurability. In 1981, New York Life reduced premium rates on certain parts of the Endowment Plan and increased maximum life insurance benefits.

10. In 1981, plaintiff received a written notice from the Endowment, which had received a dividend from New York Life, advising him that in the opinion of the Endowment's auditors and counsel, each insured member of the Endowment had in 1981 made a contribution in 1981 of 55.4 percent of any life insurance premiums paid in the period from December 1, 1979, through November 30, 1980. The Endowment further advised that the Internal Revenue Service had ruled that members were not entitled to charitable contribution deductions for any portion of their premium payments.

11. Plaintiffs, in filing their joint federal income tax return for 1981, did not claim a deduction for any portion of the gross insurance premium paid to American Bar Endowment. Plaintiffs subsequently filed a claim for refund, contending that they were entitled to an additional charitable contribution of \$108.86 with respect to dividends to the policyholder paid to the American Bar Endowment. The instant suit followed.

12. Attached as Defendant's Exhibit No. 8002 are plaintiffs' responses to defendant's first set of interrogatories.

## PART II

Neither party proposed any stipulations in *Broadfoot v. United States* which they wish to address in this part of the Memorandum Re Stipulations.

Dated: October 5, 1983

Respectfully submitted,

The United States

Herbert C. Broadfoot, II  
and Nancy L. Broadfoot

By /s/ B. JOHN WILLIAMS, JR. By /s/ FRANCIS M. GREGORY, JR.

B. John Williams, Jr.  
Acting Assistant  
Attorney General

Francis M. Gregory, Jr.

## In the United States Court of Claims

Nos. 465-82T, 163-83T, 190-83T, 320-83T, 351-83T

AMERICAN BAR ENDOWMENT, et al., PLAINTIFFS,

v.

UNITED STATES OF AMERICA, DEFENDANT

EXCERPTS FROM TRANSCRIPTS OF PROCEEDINGS  
OCTOBER 11, 1983 THROUGH NOVEMBER 11, 1983

[164] THE COURT: So your theory of the case is that the Endowment buys insurance wholesale, so to speak, and then sells it at retail to its members?

MR. DENNIS: Yes, and during Dr. McGill's deposition he indicated that this was a proper way of looking at the transaction. But they are in fact a middleman, marketing insurance to a group of individuals.

THE COURT: What is the service they are providing? Does it happen to be middleman?

MR. DENNIS: Yes, the service that they are providing is insurance to their members. That is the service that is being provided, in the same sense that any middleman—that DAV is providing a service. They provided books and trinkets to the public. The fact that one might not have title, as a middleman, to goods or services, doesn't make any difference, concerning what you are marketing. You are still providing a particular product to the public. And that is what the Plaintiff is doing in this case.

\* \* \* \* \*

[186] Whereupon,

RONALD J. FOULIS

was called as a witness by counsel for Plaintiff and, having been duly sworn by the Trial Judge, was examined and testified as follows:

## DIRECT EXAMINATION

BY MR. THROWER:

Q. Mr. Foulis, will you please give your full name and place of residence?

A. I am Ronald J. Foulis and I live in Santa Rosa, California.

MR. THROWER: Your Honor, in accordance with your suggestion that we undertake to accelerate this portion of the testimony, I will ask the witness to refer to notes and on occasion read his notes in regard to the preliminary background information that I will be asking him about.

THE COURT: That is appreciated.

BY MR. THROWER:

Q. Will you give a brief summary of your professional background.

A. I was born in St. Louis County, Missouri in 1904, attended Washington University School of Law and graduated in 1927. Admitted to the Missouri Bar in 1926; I was associated with two law firms in St. Louis [187] from the time of graduation until 1941 when I became a partner in the firm of Orr, Pflaeger & Foulis. In 1944 I was attorney for the Southwestern Bell Telephone Company in St. Louis until 1953. And then I became an attorney for American Telephone & Telegraph Company in Washington, D. C. until my retirement from the company in 1969.

Thereafter, I was of counsel to Morgan, Lewis & Bockius in Washington until the end of 1974. I am a member of the Missouri Bar, the District of Columbia Bar, the American Bar Association, the Bar Association of Metropolitan St. Louis, the Federal Bar, the Federal Communications Bar, The American Law Institute, and I am a Fellow of the American Bar Foundation. My major



Bar activity is in the American Bar Association, I have been a member since 1933. In fact, I just recently received a certificate stating I had been a member for 50 years.

I was Chairman of the Junior Bar Conference, which is now known as the Young Lawyers Section, in 1938 and '39. I was Assistant Secretary of the American Bar from 1945 to 1947. And I have served in the House of Delegates, mostly as an assembly delegate, from 1939 to 1944 and again from 1960 to 1975. I was a state delegate from Missouri from 1950 to '53. I [188] have been chairman or a member of quite a number of ABA committees, the latest of which I served as chairman of a special committee to study legal education, namely law school education for a 7 year period, from '74 to '82.

While in St. Louis I was an officer and a member of the executive committee of the Association, served as chairman of a number of committees, particularly a special committee on judicial selection and tenure and we drafted the Missouri Court plan, so-called non-partisan Court plan.

As to my civic and governmental activity, I was chief price attorney for eastern Missouri under the Office of Price Administration in '42 and '43, and a civilian member of an Air Force Evaluation Board in the Mediterranean theater in 1944 and '45. I am a vice-chairman of the Jefferson National Expansion Memorial Association and was Secretary of the United States Territorial Commission, excuse me, United States Territorial Memorial Expansion Commission, which is a governmental commission overseeing the riverfront in St. Louis where the arch was built and now stands.

I have been a member of the school board in the Ladue School District in St. Louis County for a [189] period of 6 years, '47 to '53, and was later chairman of the board of trustees of a private school, Hawthorne School, here in the District of Columbia.

Q. Would you review briefly what positions of responsibility you have held in the American Bar Endowment?

A. In 1951 I was elected Secretary of the American Bar Endowment and in 1956 was elected to the board, as a member of the board. I have served in that capacity until 1977, when I became an emeritus member of the board. I have been vice-president and president of the Endowment. I have served as a member and chairman of the Investment Committee, and also the Insurance Committee at an earlier date. In fact I am still Chairman of the Investment Committee, although I am an emeritus member.

Q. Has the Endowment always had the name American Bar Endowment?

A. It was originally known as the American Bar Association Endowment and during my term as president I arranged to drop the name "association" and change the name to its present name.

Q. In what year did the Endowment begin its group insurance program?

A. In 1955.

[190] Q. Could you briefly summarize its history prior to that date, as you understood it?

A. I am sorry?

Q. Could you summarize the history of the American Bar Endowment prior to 1955?

A. Oh, yes, in February, 1955 a special meeting of the board was—

Q. I beg your pardon. Could you summarize very briefly the history of the Foundation in the years prior to 1955, what was the Foundation doing before it adopted—

A. You are referring to the Foundation, not the Endowment?

Q. I mean the Endowment.

A. Well, the Endowment was organized in 1942 for the purpose of soliciting gifts and bequests to provide charitable work under its charter in the field of law, and

had no organized program to raise money, and during the period from '42 up until the late forties they had probably raised 15 or \$25,000, small amounts, in total.

Then about '49 or thereabouts, William Nelson Cromwell, an attorney in New York, died and left a bequest in his will which totalled approximately \$400,000. That bequest came to the [191] American Bar Endowment. The American Bar Association had occasion to move its headquarters from Dearborne Street to a more commodious location and the University of Chicago offered them a site on which to build a building. They asked the Endowment to turn over this \$400,000 to them for that purpose. The board did not do so immediately because the bequest was for the purpose of establishing a library and the directors were not about to relinquish their responsibility without knowing precisely what the plans were. Because of some delay and all, the American Bar Association decided to create the American Bar Foundation, which would hold title to this building and be responsible for engaging in research programs.

So by the end—in the early 1950s the situation was such that the grant of \$400,000 had been given to the American Bar Foundation for the purpose of building a library building and the Endowment board was discussing the necessity of raising money for charitable purposes in order to help support the Foundation in its activities.

Q. At the time of the construction of the building, was there any call on American Bar Association members for contributions to support the [192] research center?

A. The American Bar Association put on an organized campaign to raise money from its members and others and I recall at that time many of us made what contribution we could afford to make for that purpose.

Q. As Secretary of the Endowment, did you attend meetings of the board?

A. I attended all of the meetings of the board with very few exceptions.

Q. When and where did you first hear a group insurance program discussed at an Endowment board meeting?

A. In February, 1955 a special meeting of the board was called at the request of Lloyd Wright, who was then president of the American Bar Association. I was not present at that meeting but as Secretary, I had the responsibility of seeing that the minutes were prepared and placed in my custody.

The minutes reflected that at that meeting the American Bar Association requested the board of the Endowment to consider or to take action to make a proposed contract of group life insurance with the New York Life Insurance Company effective. And the board—in fact at that time Mr. William Clark Mason of Philadelphia who had been chairman of an ABA special [193] committee to see what could be done in the way of raising funds to support the Foundation presented a specimen draft of a contract with New York Life Insurance Company to the Endowment board, along with a form of application for coverage by the members under such a contract.

The board resolved that they should enter in such a contract and authorized the officers to sign the necessary papers.

Q. Let me ask, was Mr. Mason a member of the board of the Endowment?

A. He was not.

Q. Let me ask you to describe briefly the fundamentals of the plan as presented by Mr. Mason.

A. Mr. Mason told the board at that meeting and again at another meeting in August of 1955 that the Endowment might persuade its members who were interested in applying for this insurance to name the American Bar Foundation as a beneficiary under their policy, which



could possibly provide funds for the research purpose of the Foundation and the support of the building, and that furthermore, dividends which would accrue under the group policy and be assigned to the Endowment by those members, could provide additional funds, which would in the first instance [194] meet the expenses of setting up the plan and creating it and subsequently to carry out the charitable purposes of the Endowment, itself.

Q. Was there any contemplation of calling on the insured members for contributions in any other way?

A. No, simply that when they applied for their insurance they would agree that any refunds of their premiums in the form of dividends would become the property of the Endowment to carry out its charitable purposes, which were in the field of law.

Q. Was there any proposal that members be asked to make the Endowment the beneficiary under the policy?

A. Not the Endowment, but the Foundation.

Q. Was this viewed as an established plan of charitable fund-raising or presented as an experiment?

A. Well, I don't believe anybody had ever seen a plan of this sort adopted before, and Mr. Mason said that he had approached a number of insurance companies to see if they would be interested in providing a group plan of this sort and finally had persuaded them to take it on and they had no experience with such a plan before.

Q. When was the proposal next considered at a meeting of the board of the Endowment?

\* \* \* \*

[197] BY MR. THROWER:

Q. Where did the Endowment get the funds to launch the program?

A. As is reflected by the resolution at the August, 1955 meeting, the American Bar Association provided the serv-

ices of its employees and advanced necessary funds to the Endowment in order to get the program established and underway.

Q. Where did they get the staff assistance to launch the program?

A. These were the employees of the ABA.

The Endowment had no staff.

THE COURT: Did you give copies of those exhibits to the reporter?

MR. THROWER: I did not. I apologize for that oversight.

MR. GREGORY: Would it be helpful for Your Honor, we have a form. We don't have extra copies with us right now, but we have a form for exhibits. Would you be interested in having that or does the Court use its own form for noting what has been checked off?

THE COURT: I have my own form which I keep track of. I would be happy to use someone else's form [198] if you have one.

MR. GREGORY: We will get that for you. We have just a few exhibits today and we will get that for you, Your Honor.

THE COURT: This is just my handwritten form. It would be helpful because if there is a question as to what has been admitted, that would be helpful. But the reporter comes first.

BY MR. THROWER:

Q. Did I understand you to testify as to whether or not the board at the August meeting approved the proposal presented by the American Bar Association?

A. They did. It was adopted.

Q. Can you tell us what happened at the meeting of the members, when that meeting was held and what happened?



A. That meeting was held on the following day, no, two days later, the 22nd of August, following the meeting of the assembly of the American Bar Association when the meeting of the members of the Endowment was held. And the president advised the members at that time that the Cromwell bequest of \$400,000 had been paid over to the American Bar Foundation to be used in constructing a library; that [199] The Foundation would in the future require funds to acquire and maintain this library and that the Endowment, at the request of the ABA, had entered into this contract with the New York Life Insurance Company for group insurance on the lives of the members; and that the result would be payment of dividends, which would otherwise accrue to the members, to the Endowment; and that the expenses of setting up the plan would be repaid out of these dividends.

Q. By reason of your attendance, did you attend also the meeting of the members of the Endowment?

A. I did, and prepared the minutes as Secretary.

Q. By reason of your attendance at the board meeting in August are you familiar with the reasons of the board for acting on and approving the proposed resolution?

A. I am.

Q. Did the proposal reflect any assumption of significant financial risk on the part of the Endowment?

A. We did not believe so.

Q. What was intended as the principal beneficiary if any principal beneficiary of the program?

A. The principal beneficiary was to be the [200] American Bar Foundation.

Q. Did Mr. Mason make any prediction as to what might be realizable from the dividends?

A. Yes, it turned out he was a little over-optimistic as to how much would be the result of asking members to name the Foundation as a beneficiary under their policy

and he also proved to be not a very good prophet because he said he thought the dividends might eventually amount to as much as \$100,000 a year.

Q. Within what time were those predictions exceeded?

A. Within two or three years. As I recall, having reviewed the minutes recently, we received in 1957 approximately \$77,000 from dividends. In the following year \$144,000, and the year after that some \$300,000. And they continued to increase every year thereafter.

Q. Let me ask you a few questions as to how the plan worked in very broad outlines.

Who served as a group policyholder?

A. In the life program, the New York Life Insurance Company is the insurer, the insuring company. And the Endowment is the policyholder. We entered into the contract with New York Life. Then as members we apply for the insurance, the Endowment would issue [201] certificates of participation to each member.

Q. Where did the money come from to pay the premiums?

A. From the members.

Q. And then to whom was that payment made?

A. The payment was made to the Endowment, which received them and accumulated them and then paid them over to the insurance company.

Q. And, under the plan who received the dividends or premium refunds, if any, from the insurance company?

A. The Endowment received those.

(Mr. Rubloff enters the room).

Q. What was done with those premium refunds?

A. They were used first to pay the expenses of administering the program. But after that all residue was used for the purpose of making grants to applicants; at first primarily the Foundation.

Q. You stated I believe in your testimony that it was contemplated as part of the plan that the members would be asked to assign their rights in these dividends to the Endowment. Was that continued in later years?

A. Yes, it has always been continued. We have always had that provision in the application.

[202] Q. Why were the members asked to assign dividends to the Endowment?

A. If they didn't assign them, we believed that they were the property of the individuals who had paid the premium because it amounted to a return of premium.

Q. What obligation, if any, did the board recognize upon receipt of the premiums from the members?

A. Well, the board felt that they were fiduciaries and were committed to use these funds in the way that they had represented to the members they would be used, namely for the charitable purposes of the Endowment.

Q. What obligation, if any, did the board recognize with respect to dividends when they were received back from the insurance company?

A. The same answer that I just made, that this was an obligation of the board that they had made to the members to carry out the charitable purposes of the Endowment through the use of these dividends.

Q. In what field?

A. In the field of law.

Q. Now, was there any commitment, as recognized by the board, to the American Bar Association to carry out the program in the manner you have described?

[203] A. That was the American Bar Association?

Q. Yes.

A. We had agreed at the request of the American Bar Association to enter into this contract and to sell the insurance to our members with the return of dividends to the Endowment to carry out our purposes, and I suppose that was a commitment.

Q. Have these concepts of the board, and understanding of the board, to which you have testified with respect to the obligation on the receipt of the premiums from the members, the fiduciary obligation to pay them over to the insurance company, the obligation to apply upon receiving the premium refunds from the insurance company, continued throughout the later years?

A. They have been, yes.

Q. And the understanding with respect to the commitment to the American Bar Association is to carry out the program in this way?

A. That's correct.

Q. From the beginning what was the intent and purpose of the board in operating the group insurance program?

A. Well, the intent and purpose at all times was to obtain funds which could be used to make grants [204] in the furtherance of its charter purposes.

Q. What was the policy of the board, if any, regarding providing services for members?

A. The policy of the board was not to provide any service to members because we didn't think we were authorized to do so and if we had done so we would jeopardize our 503-C status.

Q. Has that policy continued to the present date?

A. At all times.

Q. Can you give any examples of the exercise of that policy in discussions with respect to the amount of the premiums, the gross premiums to be charged to the members?

A. Definitely, the board at all times wanted to be certain that the dividends under these policies would be substantial, and any suggestion, I don't recall one being made, but had any suggestion been made that we cut the costs of the insurance, the premium, down to the point where there would be no dividends, we would not have considered it for a moment.

As a matter of fact, there were occasions when we were asked to consider undertaking additional insurance programs, such as there were one or two [205] instances of travel insurance, professional liability insurance and that sort of thing, and when we determined that we could not generate dividends from the participants, we immediately rejected any consideration of those plans.

Q. Relatively, what size dividends were you insisting upon before you would agree to enter a plan, substantial or minor?

A. Substantial dividends, yes. In other words, we were not willing to undertake a program that was simply for the convenience of our members. In other words, to service the members.

Q. On what occasions does the board meet?

A. The board has a regular stated meeting at the time of the annual meeting of the American Bar Association every year, and in addition, it generally meets at the time of the mid-Winter meeting, sometime during the Spring and another time during the fall.

Those are periods when the applicants for grants from the Foundation or the American Bar Fund for Public Education have submitted their requests and we want to consider them.

Q. The representatives of those organizations attend your meetings to make presentations?

A. Generally there are representatives of both [206] the Foundation and of the American Bar Associations Fund for Public Education. At least one of those meetings every year.

Q. I will ask you, if you would, to describe Plaintiff's Exhibit — identify and describe Plaintiff's Exhibit No. 267.

A. These are the Articles of Incorporation of the Endowment reflecting amendments through August, 1977.

Q. Are the purposes of the Endowment set out in the articles?

A. Yes, they are.

Q. There is a brief statement. I would like to ask the witness to read, if he would, the purposes of the Endowment as set out in paragraph 2 of the articles, read it into the record, read it to the Court, if you would.

A. Paragraph 2 reads, "This corporation is organized exclusively for charitable, educational, literary, religious and scientific purposes, including for such purposes as the making of distributions to organizations that qualify as exempt organizations under Section 501 3-C of the Internal Revenue Code of 1954, or the corresponding provision of any future United States internal revenue law. Within the [207] foregoing the corporation's purposes in part are to advance legal studies and research and to promote the administration of justice and uniformity of judicial decision throughout the United States."

Q. Mr. Foulis, what has been the regularity of your attendance of meetings of the board?

A. I have attended virtually every meeting that the board has had unless I have been ill or something of that sort.

MR. THROWER: Your Honor, it has been stipulated I believe that this exhibit is admissible. I would like to offer it in evidence at this time.

THE COURT: Okay It is admitted pursuant to stipulation.

(The document referred to, previously marked Plaintiff's Exhibit No. 267 for identification, was received into evidence.)

BY MR. THROWER:

Q. At these board meetings has a proposal ever been made to terminate the charitable programs of the Endowment?

A. No.

Q. At the annual meetings of the members has there ever been a proposal made, by any member, to [208] ter-



minate or to study the termination of the charitable aspects of the group insurance program?

A. No.

Q. At the meetings of members, has there ever been a complaint that a member did not understand the program?

A. No, there never has.

Q. At meetings of the members, has there ever been a request from any member that the Endowment adopt the practice of returning the premium refunds to members or giving them an election as to whether to receive them or not?

A. No, there has not.

Q. Have you had occasion, over these years, to discuss the Endowment's program with members from time to time?

A. Occasionally.

Q. Have you ever heard a complaint from a member that he did not understand when he made a premium payment that a portion of it constituted a contribution for charitable purposes in the field of law, to be applied by the Endowment?

A. No, I have not.

Q. What policy, if any, did the board have with respect to keeping members of the Endowment advised as [209] to the charitable program, the amount of money raised and how it was applied, the beneficiaries receiving it?

A. At every annual meeting of the members, the president would make a statement of the operation of the Endowment during the year, the funds received, the grants made, and in more specific terms, the president or treasurer would frequently prepare a more complete statement and have it published in the American Bar Journal.

Q. As to the commitment to use the premium refunds in the field of law, to which you have testified, as a formal officer and member of the board what would have been your reaction to a proposal that the premium refunds be used for charitable purposes not in the field of law?

A. I would reject it immediately because it would not be within our chartered powers to do so or the commitments we had made to the members of the Endowment.

Q. Have you, during past years, had any ABE group insurance?

A. I did at one time, yes, in the so-called junior plan, in the early years, particularly. When I reached the age of '70 or thereabouts I didn't want to continue it.

\* \* \* \* \*

[235] Q. But in order to achieve that major purpose, didn't the board believe it was necessary to gauge the level of pricing of its insurance programs to fit within the competitive field of items available to its members, so that they would enroll?

A. We wanted to make these policies attractive to the members so long as it would result in increased dividends to us. And if it wasn't going to ultimately or basically increase the dividends, we were not as enthusiastic about it, and unless it did produce dividends of substantial amount, we were not interested because we wanted to avoid any situation where we would be said to be providing a service to the members of the Endowment.

Q. Was one of the significant considerations in increasing the amount of dividends one of getting increased enrollment in the plans?

A. Yes.

[236] Q. And pricing would have been an important consideration in attempting to increase enrollments in general, is that true?

A. Yes, we wouldn't expect members to pay an outrageously high price for insurance just to give us a dividend?

It would be much easier to go to them and say, "Make a contribution to us."

MR. MARKHAM: Thank you. Your Honor, we would move the admission of Exhibit 1740 into evidence.

THE COURT: Has that been subject to stipulation?

MR. THROWER: No objection, Your Honor.

THE COURT: No objection? Very well, admitted without objection.

(The document referred and previously marked Plaintiff's No. 1740 for identification and received into evidence.)

MR. MARKHAM: Thank you, Mr. Foulis.

\* \* \* \* \*

[243] MR. THROWER: The next witness is William Reece Smith, Jr.

Whereupon,

WILLIAM REECE SMITH, JR.

was called as a witness by counsel for Plaintiff and, having been duly sworn by the Trial Judge, was examined and testified as follows:

#### DIRECT EXAMINATION

BY MR. THROWER:

Q. Would you please give your name and place of residence?

A. My name is William Reece Smith, Jr. I reside at 11 Ladoga, L-a-d-o-g-a, Avenue, Tampa, Florida.

Q. Would you please provide for the Court a [244] brief summary of your professional background and public service activities and, here, Your Honor, again I have asked the witness to look at notes and such writings as he has prepared in that connection?

A. I don't have any.

I graduated from the University of South Carolina with a BS degree in naval science and from the University of Florida College of Law with an LLB degree I was called to the Bar in Florida in 1949 and admitted to practice in that state in various Federal courts including the Supreme Court of the United States. I taught in the College of Law of the University of Florida and was on the faculty of law of Stetson University as an adjunct professor.

Shortly after commencing the practice of law in Tampa, Florida in 1953, I have practiced law in Tampa, Florida with the firm now known as Carlton Fields, Ward, Emmanuel, Smith & Cutler, of which I am chairman since 1953. That is a firm of 100 or more lawyers with offices in 4 Florida cities.

I have practiced with that firm continually since 1953 with the exception of about a year and 1/2 in 1976, '77, when I served as interim president of the University of South Florida, and a period of about two years from '79 to '81, when I was president elect and [245] then president of the American Bar Association.

I have been active in the affairs of the organized Bar since the middle '50s. Among other things, I have served on the board and as president of the Hillsborough County, Florida, Bar Association; on the board and as president of the Florida Bar; on the board and as president of the Florida Bar Foundation; on the board and as president of the Florida Legal Services, Incorporated, which is a statewide program for the delivery of legal services to the poor.

I have served on the council and as president of the National Conference of Bar Presidents. I have served on the board or the council of the American Law Institute, the National Legal Aid and Defender Association, the Inter-American Bar Association, the International Bar Association. I have been active in various community affairs in

Tampa, Florida, either holding the office of president or serving on boards of cultural, educational and civic organizations.

I have or now serve as a member of the board of advisors, or trustee of several law schools, colleges and universities. I have served as chairman of the State of Florida's Human Rights Committee, chairman of the Governor's Commission on Protection [246] and Advocacy for the Developmentally Disabled, and as chairman of the Joint Legislative Executive Study Commission for post-secondary education in the state of Florida.

Q. You have covered this beautifully but let me ask you if you had any special scholarship of note after finishing your college and law school?

A. I did post-graduate work at Oxford University in law as a Rhodes Scholar.

Q. Did you at any time have any engagement with the City of Tampa?

A. I served as city attorney of Tampa for a period of about 9 years while continuing as a member of my law firm.

Q. Could you give me a brief review of what your positions of responsibility, if any, have been in the American Bar Association?

A. I became a member of the American Bar Association about 1955, when I attended my first annual meeting. For a few years thereafter I was active in what was then known as the Junior Bar Conference of the American Bar Association, which was representative of all lawyer members of the association under the age of 36. I served as chairman of the Junior Bar Conference with the American Bar [247] Association about 1960, '61. And I represented the Junior Bar Conference in the House of Delegates in the American Bar Association for a couple of years commencing in 1961 and 1962.

I was appointed as as Assistant Secretary of the American Bar Association in 1963 and served in that capacity until 1967.

I was elected Secretary of the American Bar Association in 1967, and served in that position for 4 consecutive one-year terms, until 1971.

I became president or was elected president-elect of the American Bar Association in 1979. Served one year as president-elect, one year as president, and one year as immediate past president. I served on a number of task force committees and commissions of the American Bar Association. And at different times chaired the ABA's Committee on assembly resolutions, the ABA's standing committee on the federal judiciary, the ABA task force on professional utilization and I presently chair the ABA's consortium on legal services and the public. I have attended all mid-year and annual meetings of the American Bar Association without exception since 1965, since 1955, correction. And I have been a member of the House of Delegates consistently since 1961 to the present date, with the [248] exception of the 4 years that I served as assistant secretary. I then sat with the House of Delegates but was not technically a member of it. I served on the board of governors of the American Bar Association for 7 years and sat with the board an additional 4 years as Assistant Secretary of the Association.

Q. Thank you.

Would you provide us a brief view of what positions of responsibility, if any, you have held in the American Bar Endowment?

A. I was appointed Assistant Secretary of the American Bar Endowment in about 1962. I served as Assistant Secretary until around 1971, when I was elected Secretary and became a member of the board of the Endowment. And I served as Secretary of the Endowment until about 1974. Vice-president of the Endowment from '74 to '76; as president of the Endowment from '76 to '78.



I served one additional year as a member of the board thereafter and resigned from the board when I became the president elect nominee of the American Bar Association. After I finished my service as an immediate past president of the American Bar Association, I was re-elected to the Endowment board and presently serve on it.

MR. THROWER: Your Honor, we had marked for [249] identification exhibit number 310, which is the biographical statement provided to us by the witness that he states is in current use. I do not have that presently with me. I would like to present that or offer that into evidence when we have it available, and I simply want to call that to your attention at this point.

BY MR. THROWER:

Q. Mr. Smith, from your observations and participation how much time do you find is spent by Endowment board members in the work of the Endowment?

A. It would vary to some degree, depending upon the responsibility of the individual member, particularly when the member becomes an officer, but I would say on the average of from one month to 6 weeks of a given year would be devoted to Endowment work.

Q. By each member?

A. By each member, yes.

Q. Are the board members paid for this service?

A. They are not.

Q. What is the American Bar Association?

A. The American Bar Association is a voluntary organization of lawyers, membership now in excess of 300,000. It's the largest organization of its kind in the world. It is generally regarded as the national [250] spokesman for the legal profession in the United States. Any person licensed to practice law in the United States, who is in good standing with the Court of admission, may upon application become a member of the American Bar Association, upon the payment of dues.

Q. Approximately what portion of the total lawyers of the United States admitted to practice are members of the American Bar Association?

A. At least 50 percent.

Q. I will ask you to identify and describe what has been marked as Exhibit No. 170.

MR. THROWER: Your Honor, I believe that the Defendant has copies of this. We will provide copies, the copy that Mr. Smith has, to the Court reporter.

THE WITNESS: This is a copy of the constitution and bylaws and the rule of procedures of the House of Delegates of the American Bar Association for the fiscal year or administrative year of 1980, 1981.

BY MR. THROWER:

Q. Were the constitution and bylaws substantially similar to this for the preceding two years?

A. Yes, they are.

MR. THROWER: I would like to offer this [251] into evidence, Your Honor.

THE COURT: No objection?

MR. MARKHAM: No objection, Your Honor.

THE COURT: It's admitted.

(The document referred to, previously marked Plaintiff's Exhibit No. 170 for identification, was received into evidence.)

BY MR. THROWER:

Q. What is the leadership of the American Bar Association?

A. The leadership of the American Bar Association might be variously described, depending on the individual who is asked the questions, but it is most certainly the officers, the members of the Board of Governors, the members of the House of Delegates, the chairs of the divisions, sections and committees of the Association. There are some of us who believe that the staff is predominantly the American Bar Association.

Q. What is the constituency of the Board of Governors? Who are they and how are they selected?

A. There are 23 members of the Board of Governors, 6 of whom are officers of the Association. 17 are elected by the House of Delegates. 14 of those [252] 17 represent geographical areas of the country not dissimilar to federal judicial circuits. The additional 3 represent the sections and divisions of the Association. The Young Lawyer Division having a representative. The sections of the Association having representatives and the Judicial Administration Division having a representative.

Q. What is a constituency of the House of Delegates? Who are they and how are they selected?

A. The House of Delegates is really the governing body of the Association. It is the chief policy-making body of the Association. It elects the officers and directors. It is composed of I believe 384 members. 52 of those are known as state delegates and are elected by the ABA membership in the 50 states, the District of Columbia and Puerto Rico. The largest constituency group of the House of Delegates of the American Bar Association are those persons that we call state bar delegates, who represent state and local bar associations throughout the country. The number of state or local bar associations to which any state, — the number of delegates to which any state is entitled depends upon the number of lawyers in the particular jurisdiction.

In addition there are 15 members of the [253] House of Delegates, who are known as assembly delegates and are elected at annual meetings of the Association by all members of the Association in attendance at the meeting.

There are also members of the House of Delegates who represent some 19 affiliated organizations. In addition, certain past officers are ex officio members of the House of Delegates, as are all members of the House of Delegates

or of the ABA and certain governmental officials are also members, such as the Attorney General of the United States.

Q. How many lawyers participate in the leadership of the American Bar Association as you have described it?

A. The American Bar Association has something which is called the red book, which lists the officers, the leadership of the divisions, sections and committees, task forces, other things of that sort. There are probably somewhere between 4500 to 5000 persons listed in that red book. In addition, there are persons active in committee work of divisions and sections of the Association and at any given point of time there are probably 20 to 25,000 individual members of the Association actively involved in some work.

[254] Q. I will ask you to describe this red book which I am handing to you and which is marked Exhibit No. 166.

A. This is the red book of the American Bar Association, actually the directory, for the year 1980, '81. It contains the name and addresses of those persons who are sometimes referred to as the official family of the Association.

MR. THROWER: Your Honor, at this time I would like to offer that into evidence.

MR. MARKHAM: Your Honor, we would question the relevance of this document to the issues in the case.

THE COURT: You wouldn't or you would?

MR. MARKHAM: We would.

MR. THROWER: May I respond to that, Your Honor?

THE COURT: Go ahead.

MR. THROWER: Your Honor, the group insurance program of the Endowment that we are reviewing here was launched and has been operated in the context of the relationship of the American Bar Endowment to the American Bar Association and other charitable arms of the Association. In order to understand the relationship of the



association's [255] concerns in this program, the relationship of the members to this program, it is necessary, we think, to have a grasp and understanding of the total operations of the American Bar Association, the scope of them, and the relationship of the Association with its members, because they are either the insured members or potentially the insured members.

The Defendant wishes to put the group insurance program in the context of credit life insurance, about which the evidence will show there have been great abuses. Or to compare the Endowment to the Exxon Corporation, or to the American Express Company. We want to see the group insurance program viewed in its true light and relationships and therefore we think this and two or three other similar documents provide important documentary support for the view that we'll have.

THE COURT: I will admit it.

(The document referred to, previously marked Plaintiff's Exhibit No. 166 for identification, was received into evidence.)

BY MR. THROWER:

Q. How may a resolution be brought before the House of Delegates?

[256] A. Most basic way would be in the Assembly of the Association. The Assembly exists to provide a forum and a voice for all members of the Association, regardless of the extent of their participation in the work of the group. The Assembly meets annually. Any member of the American Bar Association may introduce a resolution in the Assembly. That resolution is referred to the Assembly Resolutions Committee. The meeting of the Assembly on the opening day of the annual meeting of the American Bar Association, which is the largest single meeting of the Association during the year, is attended by several thousands of lawyers and guests consistently, the resolu-

tions are reviewed at the assembly. That afternoon there are hearings on the resolutions and then the assembly votes on those resolutions.

Q. May I ask at that point is there provision for discussion of the resolution or debate of the resolution?

A. Oh, yes, both before the hearings committee and in the debates which take place in the Assembly on the resolutions themselves.

Q. What vote is required to adopt a resolution in the Assembly?

A. The majority of those present.

[257] Q. Excuse the interruption and please go ahead.

A. If the Assembly approves a resolution, it's then referred to the House of Delegates for the concurrence of the House. If the House concurs then the resolution becomes policy of the Association. If the House disagrees, the resolution would go back to the Assembly. And in the event the assembly could not concur with the House, then by a vote of the Assembly the matter is referred to the entire membership of the Association through a referendum by written ballot.

Q. Is that by mail?

A. Mail ballot, yes. That is the most basic way to introduce a resolution in the association.

The American Bar Association is composed of 3 divisions, Young Lawyers, Members of the Judiciary and the Judicial Administration Division are examples of them, some 21 sections, which vary all the way from economics of the law practice to international law, and have memberships as large as many as 60,000. Many of the sections of the ABA are bigger than state bar associations.

And in addition to the 3 divisions and 21 sections of the Association there are a large number of committees, commissions and task forces. Again at one time the number would surely exceed 70. Each of [258] these entities may propose a resolution to the House of Delegates in writing.



And upon a majority vote in favor of the resolution, the matter becomes policy of the Association. There is also a provision in the rules, constitution and bylaws, which provides that any Bar Association represented in the House of Delegates may on its own, without going through the association structure, introduce a resolution for action by the House of Delegates.

In addition to the 3 ways that I have already mentioned, the resolutions may also be introduced and acted upon by the Board of Governors of the Association, which is authorized to determine matters of policy when the House of Delegates is not in session, and recommendations from the divisions, sections and committees, or sometimes from the officers, may be brought to the Board of Governors for its action.

In fact, there is something called the Executive Committee of the Board of Governors of the Association, which is composed of the officers, plus the chairs of the 3 board committees, and that Executive Committee is also empowered to act upon resolutions to approve them and to make policy. But that is very rarely done.

[259] The other measures are used pretty regularly.

Q. Is there provision in the House of Delegates for discussion and debate of resolutions before the House?

A. There is, sir. Sometime ad nauseum.

Q. Are meetings of the House and of the Assembly open to the public?

A. They are open to the public and to the press and the media is generally present at all debates carried on in the Assembly and in the House of Delegates and the Board of Governors.

THE COURT: MR. Thrower, why don't we break for lunch.

MR. THROWER: Fine, Your Honor.

THE COURT: Make it two o'clock.

(Whereupon, at 12:00 noon, the luncheon recess was taken.)

\* \* \* \* \*

[262] BY MR. THROWER:

Q. Mr. Smith, who presides over the meeting of the Assembly of the American Bar Association?

A. The president of the Association.

Q. Does the president dominate the proceedings of the assembly?

A. No, sir.

Q. Can you refer to any meaningful experiences as examples of that?

A. Well, when I was president of the Association an individual member of the Association offered a resolution that pertained to President Reagan's action during the air controllers strike. I believed that it was out of order as not being appropriate for consideration by the assembly. My ruling was appealed and overruled and the member presented the resolution successfully.

Q. Did it pass?

[263] A. It did, yes.

Q. What action did the House of Delegates take on it?

A. I believe they sustained it, Mr. Thrower, or rather approved it, although I am not certain.

Q. What are the objectives of the ABA, and I would ask you if you would to refer to Exhibit 170 which is already in evidence and Article 16 of that, perhaps you would want to read to the Court the statement of those objectives.

A. The purposes I think I know fairly well are to uphold the constitution of the United States and republican form of Government; to advance the science of jurisprudence; to advance the administration of justice; to further cordial relationships between the members of the legal profession; to enhance relationships between the national organization and state and local bar associations; seek to serve the public good. All is more fully and correctly stated in the exhibit.

Q. Could you briefly categorize those objectives as you have stated them?

A. The work of the American Bar Association per se generally divides into services and work that it does in connection with professional interests and [264] work that might be described as of public interest or public service.

Q. With respect to that latter group of activities of public service, I ask you to refer to Exhibit 335, and in a moment describe what that is.

A. This is a photostated copy of a document prepared by and published on behalf of the Public Service Activities Division of the American Bar Association. That division is composed of one section of the ABA that particularly is interested in public policy issues, the section on individual rights and responsibilities. It's composed of I guess 15 or 16 committees of the Association which work particularly in the public sector or relative to issues that are of broad public interest. And maybe 10 commissions and task forces that have commitments in that area as well. When I was president I think this particular division had a budget for its operation in excess of \$4 million annually. This particular document summarizes some of the public service activities in which the sections, commissions and other entities that are staffed by this division are involved. The document by no means comprises a summary of all of the public service activities of the American Bar Association, which are carried on not only by the association and its [265] committees but also by the divisions and sections.

One of the most active entities in the public service area is the Young Lawyers Division of the ABA, composed of lawyers under 36 years of age who now comprise about half the membership of the ABA. The group is no longer an old mossback organization but it has been youthened considerably

Q. I would like to offer that in evidence as Exhibit Number 335 at this time, Your Honor, as illustrative of public service activities of the Bar.

MR. MARKHAM: No objection, Your Honor.

THE COURT: Admitted without objection.

(The document referred to, previously marked Plaintiff's Exhibit No. 335 for identification, was received into evidence.)

BY MR. THROWER:

Q. With respect to what you categorize as the service of the American Bar Association to its members, does the ABA have any policy and practice regarding profiting on the services that it provides to members?

A. To my knowledge the ABA has never sought to make a profit on any services which it renders on behalf of the membership of the Association.

Q. Does the ABA, on occasions, secure services [266] for members or make arrangements for services for members from commercial sources?

A. Yes, the ABA as a service to members and as one of the entitlements of membership has negotiated with commercial organizations from time to time over the years and has for example obtained discounts on the purchase of office equipment, discounts on hotel accommodations, discounts in the rental car field, discounts for meeting places. It has sought to provide any number of continuing legal education programs that would cover the whole field of the interests of the legal profession of this country at cost. It has sought to provide a myriad of materials that had to do with law practice and law office economics and how lawyers can better fare in the practice of law. All of those things are done as service to membership and without a profit motive being involved.

Q. What is the American Bar Retirement Association?

A. The American Bar Retirement Association was established to provide a retirement program.



Q. Established by whom?

A. By the American Bar Association, to provide a retirement program for the staff of entities that [267] were affiliated with the ABA as well as the ABA itself, and in addition to that, to provide a body to administer retirement funds for individual lawyer members of the Association who wished to have such administration available to them. It started years ago very modestly and I think it probably now administers 3 quarters of a billion dollars a year. All of that is done as a service to those who participate without any charge whatsoever by the association.

Q. I may ask you to repeat yourself, but is there any profit to the association for the provision of these services by commercial agencies arranged by the American Bar Association?

A. No.

Q. Are there instances where the ABA does profit in dealing with commercial agencies?

A. To my knowledge, the American Bar Association has never sought to make a profit on anything that involved members and member benefits. On the other hand, the American Bar Association, if it has something to provide external to the association, might do so. As for example, the sale of the membership lists of the Association to commercial enterprises.

[268] Q. Can you state whether or not, in making that sale, any opportunity is given to ABA members to have their names removed from that list?

A. I don't think such an opportunity is provided. If so, I am not aware of it.

Q. When the ABA negotiates with commercial agencies for services to members, who or what represents the membership?

A. The officers and members of the board are elected by the membership through the structure of the Association and it's the duty of the officers and the members of

the board to represent the membership and to see that they are not only adequately but well represented in negotiations with commercial groups, such as the rental car situation. Negotiations might be carried on by one or more of the officers and members of the board, might be carried on by members of the Association in particular committee work that has special knowledge of the type of transaction at hand; might on occasion be carried on by paid consultants employed by the association to make certain that the membership interests are presented as well as possible.

The ABA is a big organization now. Is it [sic] has a great deal of leverage that it can use in [269] dealings of this kind, and it uses that leverage. In for example negotiating for convention space, special hotel rates, special air fares to go to meetings, a variety of things of that kind.

Q. As you have observed this type of representation, how would you appraise its effectiveness?

A. I believe it is quite effective

Q. Over the years in your activities in the ABA as you have described them, and in particular in your capacity as an advisor, was it ever suggested to the ABA that it introduce a low cost group insurance program as a service to members?

A. Yes, sir, that had been suggested.

Q. What was the source of the suggestion, and what was the nature of the suggestion? Who made the suggestion?

A. I remember the suggestion being made on at least one occasion by the membership committee of the Association. There have been very few occasions when members of the Association have written in, and, it might be said, urged a low cost service sort of oriented program.

Q. When this suggestion was made by the membership committee, what was the response of the [270] leadership of the ABA?



A. The leadership always carefully considers the requests and complaints and concerns of its members, and I really mean that. There is a great effort to do it. For example, as the president of the ABA, I always personally answered telephone calls from members to me and I always answered correspondence first and foremost. But the association consistently has declined to establish or support or institute in any way what you have described as a low cost insurance plan as a service to members.

Q. Can you tell us why that is the case?

A. Well, historically the American Bar Association asked the American Bar Endowment to institute the insurance programs which bring us here on this occasion. The primary purpose was not to sell insurance but to raise funds for charitable purposes. The American Bar Association, having asked the Endowment to undertake such a program, and the Endowment having developed such a program, and in the viewpoint of the leadership of the Association, done so successfully, so that the donations made by the certificate holders are of very significant meaning in the public service activities and research activities that are law-related in this country. This being so, [271] the leadership would not want to start a service, low cost service insurance program because it's inconsistent with that which it asked the Endowment to do, because it could create confusion because it is antithetical to the purpose for which the program was established in the first instance.

Q. Are you familiar with whether state and local bar associations have adopted group insurance programs for its members?

A. Slowly over the years they have done so. I believe I am correct in saying that there are some 50 state bar association life insurance programs now and at least 50 disability insurance programs. A vast majority, if not all of those programs, are what I would call service oriented

programs. They exist primarily to attract and hold membership. They have no other feature or no other purpose. They are entirely different in design and purpose and goal from that which the American Bar Endowment has developed over the years.

Q. As you understand it, do they undertake to profit from the sponsorship of those programs?

A. The state bar associations?

Q. Yes.

A. By and large no, they do not. They try to [272] provide the coverage at the lowest possible cost as a service.

Q. With what regularity have you attended meetings of the House of Delegates during your years of service in the House?

A. Constantly. I have never missed a meeting.

Q. And meetings of the Board of Governors?

A. When I served on the Board of Governors, the same was true.

Q. And meetings of the board of the Endowment when you were on the board?

A. I didn't do quite as well on the Endowment particularly in my earlier years because my career has been as a trial lawyer and in the earlier years I worked for older lawyers and when they told me to be ready for trial I was there and I missed some Endowment meetings.

Q. And could you state the extent of your attendance at board meetings, were you frequently absent?

A. Which board, Mr. Thrower?

Q. Of the Endowment, which you referred to.

A. I was absent on occasion during the period from '62 to '71 when I was Assistant Secretary. I don't think it was frequent, but it certainly occurred. [273] I did even better in my attendance during the period that I served as an officer of the Association, at least until the time that I became a candidate for president of the American Bar Association.

Q. And meetings of the Assembly of the ABA?

A. I have attended all meetings of the Assembly since 1955.

Q. And the annual meetings of members of the Endowment?

A. I have attended all annual meetings of the members of the Endowment since 1962.

Q. To your knowledge has any resolution ever been presented at any of these meetings to propose that a low cost group insurance program of service to members either be introduced or that the prospect of introduction of such a program be studied?

A. None have ever been introduced or even discussed.

Q. Any resolution, in the ABA meetings that you have just referred to, to terminate the group insurance program?

A. No, sir.

Q. Any proposal in any of the meetings that you referred to that an annual election should be given to ABA members to either take down or leave their [274] contributions, leave their premium refunds with the Endowment for charitable purposes?

A. No, sir.

Q. In what ways, if any, does the ABA support the group insurance program of the Endowment?

A. Well, it really gave it birth, which I suppose is considerable support. In addition to that, it provides, it nurtures it because it provides the total membership of the Endowment. It supports it in entirety, particularly in responding favorably to the public service programs and research programs, that the Endowment has carried on, in giving those programs appropriate publicity and recognition over the years.

The American Bar Foundation, which is the research arm of the American Bar Association, could not have existed but for the support of the American Bar Endowment and the ABA clearly recognizes and acknowledges this.

The ABA is aware of other interests, other associations whose welfare it is interested in, that have been and continue to be heavily reliant upon Endowment for support. Probably the National College for State Judges at Reno, Nevada, would not have become the success it has without the early support of the American Bar Endowment. The core administration [275] support of the National Legal Aid and Defender Association has come from the Endowment for many years.

The National College of District Attorneys receives vital support. There are others I could name. The Association recognizes the importance of all of these groups, many of which were inspired by and are nurtured by the Association.

It regards them not only to serve in the professional interests but in the broad public interests of this country and the Association appreciates the importance of the Endowment in sustaining activities of this kind

Q. Can you state whether or not you would consider that the forbearance of the ABA from introducing low cost group insurance programs as a service to members would be a type of support which the ABA gives to the Endowment?

A. No doubt that that is true.

Q. In your view could the Endowment have been launched or could the group insurance program of the Endowment have been launched or carried on without the support of the ABA?

A. I think not, sir

Q. As far as you know has any insured member of the Endowment ever complained to the Endowment [276] officers or board, at any of the meetings or otherwise, that when he paid his premiums he did not know of the charitable nature of the premium refunds?

A. I have never heard of such a complaint.



Q. By reason of your years of service with the board of the Endowment and as a [sic] officer are you familiar with the concepts and understandings of the board regarding the operation of the group insurance program during the years of your relationship with the Endowment?

A. Yes, sir.

Q. When premiums were paid to the Endowment by the members, what obligation, if any, did the board recognize regarding that money?

A. The board had a fiduciary obligation to receive that money and to pay it to the insurance carriers presenting the program.

Q. Why were the members asked to assign any premium refunds to the Endowment?

A. Because it has been the understanding from the beginning that were it not for the assignment, the so-called premium refund would be due to and should go to the individual certificate holders. That was the background against which group programs of this sort developed. It was the understanding of board members [277] that they were entitled to the premium refunds, as a matter of law or equity, and that the assignment was necessary because that was so.

Q. When the Endowment received premium refunds from the insurance companies, after expenses, what obligation, if any, did the board recognize regarding that money?

A. The program was conceived from the beginning as a method for it might be called small gift contributions in aid of the legal profession. The certificate holders or members of the Endowment were advised that if they made contributions to the Endowment, those contributions would be used in the area of research and public service in the field of law, and law related activities. This was the constant expression of the Endowment, the understanding of those who had helped create it, namely the

American Bar Association, and the Endowment leadership, if one wishes to call it that, felt committed to use the funds according to those undertakings consistent with the charter powers of the Endowment, and consistently over the years of the Endowment leadership the board did precisely that. As far as I know they never made a grant outside of the field of law.

[278] Q. Summing up, did the board consider the premium refunds to be profits after expenses or charitable contributions to the Endowment?

A. Charitable contributions. Have never been conceived as profits.

Q. On what basis were decisions made by the board as to what types of insurance to cover?

A. The board from time to time looked at various insurance programs over the years that I can recall. If the programs did not promise to provide what you have called here premium refunds of substantial circumstances; if they were high risk programs or offered low margin of return if one wants to call it that, the Endowment was not interested in it and did not pursue them further. Over a period of time the Endowment looked at things like Medicare supplements and travel care insurance. I am sure there are others. They don't come immediately to mind.

Q. Turning now in conclusion to the spending of the money by the American Bar Endowment, can you describe briefly the relationship of the ABA, the American Bar Foundation, the Fund for Public Education and the Endowment?

A. Well, the ABA is the voluntary organization of some 300,000 lawyers, which might, among those that [279] you have mentioned, be regarded as the parent organization.

The American Bar Foundation was created for the purpose and continues to serve as the research arm of the American Bar Association and the American legal profession.



The American Bar Foundation was created for the purpose and continues to serve as the research arm of the American Bar Association and the American legal profession.

The American Bar Endowment was created as the charitable arm of the national organization, each independent of the other serving in their respective areas. The Fund for Public Education is a less independent entity, a 501 C-3 organization created by the American Bar Association for the purpose of receiving and making grants appropriate within the confines of 501 C-3.

Q. Was its interest confined to the legal field or did they extend more broadly?

A. The Fund for Public Education?

Q. Yes.

A. Again, its activities are limited to matters of law. The distinction to be made between the activities of the American Bar Foundation, on the one hand, for example, and the Fund for Public Education on the other, is that the American Bar Foundation is interested in research activities. The Fund for Public Education is involved in programmatic [280] activities.

Q. What has been your principal interest on the board of the Endowment?

A. My interest more than anything else was in the grants activities of the Endowment and I suppose in seeking to assure that the contributions of the members were used effectively to advance research and public service in the field of law and beyond that to determine the priorities, because there were always or nearly always far more demands than there was money. Judgments had to be made as to where it could best be spent in the public interest and in the interests of the legal profession. Some of the best fights that I can remember within the Endowment related to decisions regarding priorities.

Q. In its grant-making is the board of the Endowment subservient to or subject to the directions of the ABA? Or is it independent of the ABA?

A. Not in the least. Frequently one would have to withstand the pressures of the given president of the American Bar Association, who had a project that he was particularly interested in.

Q. In providing—in responding to requests for grants, did the board study the reasons for which the money was requested or just turn it over?

[281] A. The board was very careful to assure that it understood in the first instance the purpose for which the grant application was made and the application that would be made of the funds if received. The board was very careful to assure that the grant was within the charter powers of the Endowment. The board was very careful to understand the merits of the application, and beyond that, to try to evaluate it in the overall picture of that, which was of law-related, public and professional concern at the time. And serving on the grants committee, which is one of the things I liked about it, one had to have a pretty broad knowledge of what was going on in the field of law and the legal profession in this country, and what was deemed to be of particular concern at a given point of time.

Q. Did the board, through the grants committee, follow up to see that the grants were extended in a manner consistent with the requests?

A. It did. It required oral or written reports, mostly written reports, to assure that the monies were spent for the purposes for which they were granted.

Q. What has been the policy of the board of the Endowment with respect to informing their members about the charitable programs of the Endowment?

[282] A. It was thought it would be very important to inform the members, since they were contributing their money to the Endowment for grant purposes. It was

regarded as very important that the Endowment keep the members advised of the uses to which the monies were being put, and assuring in effect the members that the fiduciary obligations of the Endowment were being properly discharged. And therefore, there were annual reports. There were separate mailings of the American Bar Endowment. There were reports published in the American Bar Association Journal, along with budgets. There were articles written in the American Bar Association journals. There were speeches made by officers of the Association, particularly the president of the American Bar Association, as he traveled about the country meeting with lawyers and Bar associations, talking about these activities and their importance to the public interest of this country and to the legal profession.

Q. Is the group insurance program of the Endowment the only way in which ABA members give money to charitable causes supported by the ABA?

A. No, it is not. It is the most effective small gifts program, obviously over a long period of time. The American Bar Association not long ago itself [283] completed a successful \$10,000,000 fund-raising drive, which was called the Second Century Fund. The American Bar Association is now developing an annual giving program. By and large these involve gifts of greater magnitude than those that are involved through the Endowment concept.

Q. And then are there also other ways — I need not ask you to enumerate them in detail unless you care to?

A. Well, the American Bar Foundation, for example, has something which it calls the Fellows of the American Bar Foundation, and it's regarded an honor to be invited to be a Fellow and one contributes \$1,000 for the honor, which goes to the support of the American Bar Foundation.

So there are a variety of ways in which one can give to the legal profession in this country, none with the consistency nor the concept of the Endowment.

MR. THROWER: That concludes my direct, Your Honor.

THE COURT: Okay, Mr. Thrower. Mr. Markham.

MR. MARKHAM: Thank you, Your Honor.

\* \* \* \* \*

[297] Joseph W. Moran

was called as a witness by counsel for Plaintiff and, having been duly sworn by the Trial Judge, was examined and testified as follows:

#### DIRECT EXAMINATION

BY MR. [sic] CARPENTER:

Q. Would you state your full name and business address.

A. Joseph W. Moran. My business address is 51 Madison Avenue, New York City.

Q. And by whom are you employed?

A. I am employed by the New York Life Insurance Company

Q. And what is your position?

A. My title is vice-president and actuary

Q. What is an actuary?

A. Well, an actuary is generally viewed as someone who uses mathematical principals [sic] and concepts, particularly as they relate to probability and statistics and time value of money to solve practical business problems, particularly in the area of insurance, but also in the area of other business [298] questions involving contingencies.

MS. CARPENTER: Your Honor, Mr. Moran is being offered by the Endowment not only as a fact witness but also as an expert witness and in the interest of saving time I have asked Mr. Moran simply to state for the Court what his education experience and qualifications are in the field of actuarial science.

He will be offered as an expert in group life insurance.



THE COURT: Is there likely to be an objection from the defendant?

MR. MARKHAM: No, Your Honor.

THE WITNESS: I have been employed by the New York Life Insurance Company since 1949, when I was hired after graduation from Yale, honors with exceptional distinction in mathematics. Throughout that period of time I have temporarily been assigned to various positions in New York Life's group insurance operations. Over 30 years I have had experience with underwriting various actuarial assignments, including responsibility for premium ratemaking and financial projections, and for a period of time I had full operating responsibility including sales for our association group insurance operations.

[299] I acquired my fellowship in the Society of Actuaries by examination in 1952. I became a charter member of the American Academy of Actuaries in 1965. Within the Academy of Actuaries I am a member of the Committee on Guides to Professional Conduct. Within the Society of Actuaries I have had several committee assignments through the years, including a 10-year stint on the Committee on Group Mortality and Morbidity, which conducted inter-company experience studies.

Most recently I have been, for the last 4 years, a consultant to the Society of Actuaries Committee on Examinations and Education Consultant on group insurance products.

MS. CARPENTER: With the record properly made we offer Mr. Moran as an expert in the field of life insurance.

THE COURT: In light of Mr. Moran's obvious qualifications and lack of objection, he is so qualified.

BY MS. CARPENTER:

Q. Mr. Moran, could you describe your duties during the period July 1, 1978 to June 30, 1981?

A. For the periods under discussion up through the end of April, 1981 I was the officer with [300] principal responsibility for New York Life's professional association group life and health insurance operations, including underwriting, actuarial, pricing, financial results and sales. During part of that time we were operating on a committee basis. I didn't have line responsibility for all of those activities but I was the chairman of the committee that all the activities reported to.

Beginning in the Fall of 1979, and extending through April of 1981, it was a line responsibility.

In May of 1981 I was transferred to a new assignment, staff position, and reported directly to the executive vice-president in charge of group insurance operations, and that is my present position and I handle certain special projects, particularly the area of long-range planning.

Q. Did your responsibilities during the period July 1, '78 to June 30, 1981, which I will refer to from here on out as the years in issue, include responsibility for the American Bar Endowment case?

A. Yes.

Q. Did you have the authority to determine the rates on that case?

A. Yes.

[301] Q. How long were you involved with the American Bar Endowment case?

A. My first involvement with the American Endowment Group Life Plan began in 1953.

Q. Can you tell me how you came to become involved in it?

A. William Clark Mason, who was the chairman of an American Bar Association committee that was undertaking the proposed development of a life insurance program visited New York Life's home office and met with several of the key people in our group insurance department.



Mr. Mason's idea was to devise a group insurance plan under which the American Bar Endowment could raise funds to be used for educational and research purposes. His proposal was that the fund-raising would be accomplished in two ways, that some members of the Endowment insured under the plan would designate the Endowment as the beneficiary for their life insurance coverage, and, above and beyond that, the Endowment as policyholder would be entitled to receive the dividends of the group insurance policy as might be payable by New York Life from time to time.

Q. Mr. Moran, at that time were you aware of any other group life insurance plan that had as its [302] purpose fund-raising.

A. I was not familiar specifically with any group life insurance plans that operated on that basis.

Q. And at that time did professional associations commonly offer life insurance to their members?

A. It was unusual for them to do so.

Q. And did the New York Life Insurance Company have any other professional association cases at that time?

A. No.

Q. During the years in issue, what companies were the leading companies in professional association insurance?

A. I would say in the late 1970s New York Life was probably the most prominent company that was active in the association group market. Since then Prudential has become quite active so that statement would not apply today, since Prudential is larger than New York Life. But in terms of relative levels of activity in association group New York Life undoubtedly had the largest volume of group life insurance on the books under group policies issued to professional associations.

Q. Can you name some of the other companies [303] that were leaders during the years at issue?

A. Mutual Life of New York had been active for years and there were a number of other companies that had specialized, Sentry Insurance Companies, for example, and, as I say Prudential had some business on the books but they had not been actively engaged in that marketplace.

Q. Mr. Moran, did you participate in the design of the original ABE life insurance program?

A. Yes, at that time I was head of our group underwriting division and my role was the determination of what schedule of amounts of insurance could be offered at a set price of \$20 per year per insured member under the original plan. It was a housekeeping matter of taking a premium rate table and turning it inside out so to speak to determine the amounts of insurance for a specific price.

Q. Whose idea was the \$20 a year premium?

A. I would say that that was collective brainstorming. I couldn't pinpoint the extent to which anyone came into that initial meeting with a preconceived idea.

\* \* \* \* \*

[307] Q. Now, did the New York Life Insurance Company pay anything to the American Bar Association for bringing the Endowment account to New York Life?

A. No.

Q. Did New York Life pay Mr. Mason anything for bringing the Endowment account to it?

A. No.

\* \* \* \* \*

[311] Q. I take it then that your suggestions were always to decrease rates?

A. Our suggestions and proposals and recommendations had always been in the direction of decreasing rates. But of course our posture with respect to making such recommendations was always controlled and influenced to

a large extent by our awareness of the fundamental purpose of the plan, which was the generation of dividends to the Endowment.

Q. How would you describe the Endowment's attitude toward decreases in rates?

A. During the 1960s, they were reasonably aggressive about plan improvements and pricing improvements to help build up momentum in the growth of enrollment. After the new series plans were installed in 1972, by which time the volume of insurance under the plan had gotten so big, and the experience had been so favorable that dividends had become quite large, we began to observe a general pattern of apprehension about further pricing liberalizations because liberalization of the price of insurance to the insured members might reduce the potential for dividend income to the Endowment.

Q. During the years in issue, if fund-raising had not been the goal of the Endowment would New York Life had been willing to set gross premium rates at a level substantially lower than those in effect?

A. Unquestionably.

Q. During that same period, would New York Life have been willing to enter into a group insurance contract that provided that any dividends to the policyholder would be used to reduce the cost of insurance to ABE members?

A. Yes.

Q. How does a dividend to the policyholder affect the price of insurance?

A. It reduces the price of insurance. Whether it reduces the price of insurance to the individual members who are insured under the plan depends on whether the dividend is passed through or whether there is a pass-through of portions of the dividend to those insured members.

[313] Q. During the years in issue did any of the professional association group plans underwritten by New York Life use dividends to reduce the cost of insurance to their members?

A. Yes.

Q. What percentage or what proportion did that?

A. I would say that about half of the association group plans, including a couple of the very largest, passed through the entire amount of dividends received from New York Life to reduce the cost of insurance to the members. Some of the other groups passed through a portion of the amounts received as dividends to reduce the members' insurance costs and in some instances applied a portion of what they had received as dividends to cover certain costs which they viewed as related to the management and supervision of the insurance plan itself.

Q. Did any of the professional association groups besides the Endowment retain the entire dividend?

A. Not that I know of.

Q. When the dividends were used to reduce the cost of insurance for the members of the other groups, what entity applied the monies for the benefit of the members, was it New York Life or was it the group [314] policyholder?

A. Under all of our group policies on which we paid dividends, we would disburse dividends to the group policyholder and the administrator of the plan, usually an independent organization, who would then make the calculations to determine the amounts from that dividend to be credited to the individual insureds. In at least one instance the calculations and the allocation of those credits were made by the policyholder association itself.

Q. We have talked a little bit about professional association group. What is professional association group?

A. Well, we view a professional association group as group policies under which an association of professional



people, doctors, lawyers, accountants, etc., contracts with New York Life to act as a buyer of insurance on behalf of its members.

And it in effect negotiates a deal with New York Life as to the terms on which New York Life will make certain forms of insurance available to the members of the association.

Q. Excluding for a moment the American Bar case, what is the purpose of a professional association sponsoring a plan through New York Life Insurance [315] Company?

A. In general, the primary purpose of sponsoring a life insurance plan for an association as to strengthen the relationship between the association and its members, or strengthen the bonds that tie the members' common interests together, to reinforce the existing relationship that already exists.

Making a service like insurance available to the members is viewed by associations as one way of doing that. In the American Bar Endowment case, we viewed that the opportunity to combine the fund-raising objective of the Endowment with the ready availability of insurance under an American Bar sponsored plan was an attractive feature of the program.

Q. Suppose that during the years in issue the Endowment had come to you and said, "We are going to give up our fund-raising goals with respect to our insurance plan. The American Bar Association would like to take over this plan and make it a low cost service to members program." Would you have been willing to enter into a contract with the ABA on that basis?

A. Quite eagerly.

Q. I am sorry, I didn't hear you?

[316] A. Quite eagerly.

Q. Mr. Moran, what is mutual insurance?

A. Mutual insurance is a mechanism for attempting to deliver insurance protection to a group of policyholders at cost. It relies on the contribution from the policyholders, who collaborate much in the way that a cooperative might be established, in establishing a pool of surplus contingency funds to cover losses that might be sustained; in a way that makes it unnecessary to obtain capital from outside sources. And by not relying on outside sources for capital in the form of common stock, ownership stock, the insurance company that is created is able to save one element of the cost of providing the insurance protection and deliver the insurance coverage to its policyholders at cost.

Q. When you say "at cost," what does that mean?

A. Well, the costs are the sum of the amounts paid in benefits plus the costs of administering a program, minus whatever investment income is generated by the funds held by the insurance company.

Q. What would be the relationship between the initial premium paid by a policyholder and the cost?

A. Under most mutual insurance schemes the premiums paid in by the policyholders represent, in [317] effect, a guaranteed maximum cost of insurance, and any balance that remains, the excess of those premiums over the realized actual costs of providing the insurance, are available for surplus and the management of the insurance company determines what portion of that surplus is distributable to the policyholders as a cost reduction.

Q. Is New York Life a mutual insurance company?

A. New York Life is a mutual company.

Q. And is the American Bar Endowment policy a participating policy?

A. Yes.

Q. Would you define a participating policy?

A. A participating policy is a policy which provides that the policyholder will share in the divisible surplus of the insurance company as ascertained by the insurance company and as apportioned among its policyholders.



Q. Does a mutual insurance company such as New York Life make a profit?

A. The word profit is one that is awkward to use in conversation, when you refer to a mutual company. Profits are in effect retained surplus not yet distributed as dividends, not yet distributed to policyholders?

[318] Obviously, a large thriving organization must operate in an atmosphere of expecting that its surplus funds will grow, corresponding to growth in the size of its business operations. And I would say that we internally describe growth in surplus, money received and retained, and not yet distributed to any policyholders, as profit.

Q. So you would call what would otherwise be termed profit on the group insurance contract, you would call that contribution to surplus?

A. That's correct or —

Q. Or a charge for risks and contingencies?

A. That's correct.

Q. We have some discussion today about dividends. Could you tell us what is a dividend?

A. A dividend is, in the interest of a mutual insurance company's participating group life insurance policies, is the excess of the premiums over the amount that the insurance company determines to have been the cost of providing the insurance under that policy, after deducting — I am sorry, after taking account of benefit costs, expenses and investment income.

Q. How does New York Life go about determining the dividends on the American Bar case or any other [319] group case?

A. Each year the management of the group insurance operation develops scales of dividends for use in the following year. These scales include formulas and factors for computing various quantities. The dividend scales are submitted to New York Life's Board of Directors for approval. Upon approval by the board, the group depart-

ment then subsequently makes the dividend determination for each insurance risk by applying the factors and formulae in the scale to the specific data for each group insurance policy.

Q. Mr. Moran, is there a basic formula for calculating the dividend that you could put on the blackboard for us?

A. An over-simplified version of it, I do.

(Witness writes on the blackboard)

The dividend equals premiums plus investment income —

Q. When you say premium you mean gross premium?

A. That would be the gross premium income received. Investment income comes from the cash that is in your hands that hasn't yet been paid out as benefits or for any other purpose. Benefit costs, that is essentially claim payments that we have made plus the costs of maintaining reserves for liabilities [320] that haven't yet been paid out. That would include reserves for situations where a member has died and we don't know about it yet or a member has died and we know about it but the benefit hasn't been paid out yet because of paperwork still in progress, and it could also involve things like unreported disabilities where upon discovering that the individual has been disabled, we'll have an obligation to continue his coverage indefinitely without further premium payments, the so-called waiver of premium reserves.

One other item in benefit costs would be the cost of conversions to individual policies on termination of insurance. The group insurance companies customarily have to reimburse their individual insurance operations every time there is a conversion of insurance on termination of membership

Q. That conversion would be required by state law?

A. The conversion is required by state law, yes. Expenses would include our own operating expenses for what our own people do. It would include what we pay others for handling various sales and administrative functions.

It certainly includes the commissions that we pay to a broker. It also includes premium tax charges. And it includes, particularly with [321] reference to the Endowment's plan, federal income tax costs.

Risk charge. We have referred to that earlier, that is the contribution to surplus; the modest amount that we consider as New York Life's current profit that is added to our surplus to help strengthen our ability to assume more insurance risks in the future.

The last item, allocation to special reserve, relates to the fact that under certain plans, where the spread between premiums and expected costs is not large, there is reason to establish certain special contingency reserves that can represent an additional cushion to rely on to absorb fluctuations in the cost of insurance. And so we have a generalized provision for building up special contingency reserves on group policies and this allocation can be either a charge against current year premium or it can be a negative item if we release some amounts that we have previously held in special contingency reserves.

Q. With respect to the Endowment case do you have any special contingency reserves?

A. We do not now have any with respect to the American Bar Endowment life insurance plan.

Q. Was that also true in the years at issue?

[322] A. That was true for this entire period at issue.

Q. With respect to the Endowment we can simply erase that last factor in the formula?

A. That's correct.

Q. Now, with respect to the 3 remaining factors, what would be the largest factor in determining the Endowment's dividend?

A. Well, of the deducted items it would be benefit costs. Benefit costs for a group, for an association group life plan, are typically anywhere in the neighborhood of 50 percent of premium or larger. There are a few instances where they run smaller.

Q. Would the Endowment be able to control those benefit costs?

A. Not unless they are clairvoyant or extremely selective in their membership or in their mailing and solicitation literature.

Q. Mr. Moran, directing your attention to the years at issue, did the dividend paid to the American Bar Endowment by New York Life include any payment for sponsorship of the group life insurance program?

A. No.

Q. Did it include any payment for endorsement of the group life insurance program?

[323] A. No.

Q. Did it include any payment for bringing the group to New York Life?

A. No.

Q. Did it include any payment for services as a market maker?

A. No.

Q. Did it include any payment for services as a broker?

A. No.

Q. Did it include any payment for services as an insurance agent?

A. No.

Q. Did it include any payment for any assumption of any underwriting risk?

A. No.

Q. Did it include any payment for any services at all?

A. No.

Q. Did it include any payment of an entrepreneurial profit or fee?

A. No.

Q. During the years in issue did the Endowment provide New York Life with its own mailing list or with the American Bar Associations mailing list?



[324] A. No.

Q. Yesterday the Court asked Mr. Gregory what a group policyholder was. Could you define a group policyholder for the Court?

A. I would define a group policyholder as an organization, or in some instances an individual, who contracts with an insurance company's for the insurance company to provide insurance on the lives of a group of individuals who are represented by the policyholder in their negotiation of the terms of this insurance arrangement.

Q. With respect to the professional association group policyholders that you have at New York Life, what are their responsibilities in relationship with New York Life?

A. Well, they all certainly have the responsibilities for overseeing or in some instances dealing directly in negotiations with New York Life over the terms of the group program, including coverages to be provided, premium rates to be charged, administrative arrangements to be established, the services that they expect New York Life to provide as part of the operation of the plan, the designation of the broker, and whether that broker will assume certain sales responsibilities, the designation, [325] perhaps, of an administrator to perform administrative responsibilities.

Q. During the years in issue did New York Life compensate any of its group policyholders for performing any functions?

A. No.

Q. You made reference a minute ago to an administrator. Could you define that, please?

A. Well, there are a number of administrative functions that have to be handled by somebody in connection with the operation of group insurance plan.

These, in many respects, are the counterparts of administrative functions that an employer handles under a traditional employer/employee group insurance plan,

such as tallying up the records as to who is insured under the policy, and keeping a record of who is insured, what kind of insurance they have, getting premiums remitted to the insurance company, and so forth.

Q. Would those functions include enrolling eligible people in the plan?

A. They frequently do include the enrollment of the people who are eligible for the insurance, yes, in an employer group plan that is traditionally the case. In an association group plan that may be handled by [326] the administrator or by the broker or by the association.

Q. We diverted from what an administrator was. What is an administrator?

A. There are functions that have to be performed. Some associations are not equipped to perform those functions themselves. Others might be equipped and capable of doing so, but for one reason or another prefer that the administrative functions be handled either by the insurance company itself or by an independent organization, acting on behalf of the insurance company, subject to selection by the association.

A. There are a number of firms acting in the business as broker administrators, specialists. In some instances they are performing services on behalf of the association, and on behalf of insurers in connection with insurance programs. In some instances supplemented by other activities performed on behalf of association clients. The organization that acts as an administrator is usually also a brokerage organization, or at least another corporate arm of an organization that has a brokerage operation.

But it may be an independent operation or it may be, in some instances, part of the insurance [327] company. New York Life acts in effect as administrator on some types of group insurance.

Q. Now, if there is an administrator involved in a New York Life professional association group case, who compensates that administrator?



A. New York Life.

Q. Suppose there is no administrator, and the administration functions are done by the policyholder, is the policyholder compensated by New York Life?

A. No.

Q. Does the Endowment have an administrator?

A. The Endowment does its own administrative work with respect to the New York Life group policy.

Q. During the years in issue did New York Life have any other groups that did their own administration?

A. Only one professional association group handled the full array of administrative functions comparable to what the American Bar Endowment did, and that was a Canadian group, the Ontario Medical Association.

Q. Did that group return the dividends it received to its members?

A. I believe it returned to members an amount that actually exceeded what they had received from New [328] York Life in dividends because they had an arrangement under which certain funds that had been paid in by members were held by the association and earning interest so that the amount available at the end of the year included not just the New York Life dividend.

But they did pass it all back to the members.

Q. During the years in issue was the Endowment authorized to issue certificates of coverage to members who enrolled in the life program?

A. Yes, technically from a legal sense I think New York Life issues,—they were authorized to prepare and distribute certificates describing the insurance under the New York Life group policy.

Q. Were these certificates cleared in advance with New York Life Insurance Company?

A. Oh, the content of the certificates was very definitely determined by New York Life and filed with the regulatory authorities.

\* \* \* \* \*

[338] A. This is a very familiar document because I prepared it myself and this is what appears to be the final text of the report that I prepared in October, 1980 to the chairman of the Insurance Committee of the American Bar Endowment at his request.

Q. What was the purpose of the report?

A. The purpose of the report was to review the claim experience and the competitive situation as they related to the American Bar Endowment's Life insurance plans in the Summer of 1980.

Q. What was the reason for the review?

A. The reason for making the review was that I attended the Insurance Committee meeting of the American Bar Endowment in June, 1980 and the Insurance Committee chairman asked me a question, "What is happening in the competitive area with respect to our life insurance plan?" And I answered with several comments that the competitive marketplace was changing dramatically, not just with reference to availability and price of group life insurance plans that might be alternatives to the American Bar Endowment, but most dramatically with respect to the prices of individual term life insurance.\* \* \*

\* \* \* \* \*

[343] BY MS. CARPENTER:

Q. The premium on the black board you are showing us?

A. Yes. The second line, "interest credits before federal income tax charges," that is New York Life's statement of the investment income apportionable in this contract based on New York Life's investment experience.

Q. So in this particular year marked "current year" the first the item in the formula there, "premium plus investment income" would add up to 106 percent of premium?

A. That's correct. "Benefit costs," the amount showed is incurred claims in the exhibit.

Q. So the 36 percent there would include actual claims plus any reserves for pending claims, etc.?

A. That's correct.

Now, items 3, 4 and 5—I am sorry, items 4, 5 and 6 together make up "expenses," in other words, commissions paid, item 5, the charges for premium [344] taxes, charges for federal income taxes and charges for New York Life's own expenses add up to the expenses item.

Q. Let's go back to item 4. What's commission, referred to here?

A. Those are the commissions paid to Fred S. James & Company, or James Group Services, the organization that is designated as broker by the ABE and which has responsibility specifically for consultative and advisory services with respect to this plan. They do not have the responsibility for enrollment solicitation activity.

Q. Am I to understand that New York Life pays James Group Service, and then New York Life turns around and charges the Endowment against its dividend for whatever payment is made for James Group?

A. That's correct.

Q. And then could you explain the premium taxes and federal income tax charges?

A. The premium taxes are basically determined by applying the various premium tax rates in the specific states to the distribution of enrollment of members under this group policy by state. Each state's share of the total premium received by New York Life on the Endowment group policy is added to [345] the premium income recorded for that state by our controllers department for purposes of determining the premium taxes payable to the state. And likewise, we get tax credits from some of those states with respect to the dividends paid to the Endowment, and those credits are also passed back through to enhance the dividends.

Q. So the premium taxes and federal income tax charges shown are payments made by New York Life that are then charged against the Endowment's dividend?

A. Yes, it's the Endowment's formulated share of what we have determined to be the total taxes assessed against our group insurance operations.

Q. What makes up the expense charges that are listed in line 6?

A. Well, on the Endowment's plan there are charges for several types of activities that New York Life performs on this case. One is the cost of administering claim payments for claims incurred on this plan. The claims on this case are handled by New York Life claim offices, primarily our claim office in Chicago, but also our home office claims organization and they handle the processing and disbursement of benefits and all the life insurance claims on the case.

\* \* \* \* \*

[352] Q. Now, how does that number, 10,000 members in New York State, compare with the number of members enrolled in the Endowment group life program?

A. The enrollment in the Endowment group life program has been dropping to the point where I believe it has now fallen below 50,000. It was between 40 and 50,000 for the years in issue that you referred to earlier.

Q. In how many states was the Endowment plan available during the years in issue?

A. The Endowment plan was generally available in all states during the years at issue although there were some restrictions on availability in Texas during part of that time. I don't know that the plan was available in Texas throughout the period.

\* \* \* \* \*



[355] Q. Mr. Moran, with respect to Exhibit 297, may I direct your attention to Exhibit Roman III. And specifically direct your attention to the middle of the page where it says "breakdown of balance." And there is an Item 7-A, "charges for compensation." Could you explain what those charges are?

A. Well, there are two categories of charges for compensation because we pay compensation in two parts to the Bertholon-Rowland, that is a prominent brokerage firm in New York City, which is the broker designated by the New York State Bar Association with respect to this plan and also acts as administrator to perform certain administrative functions on the plan. The figures shown in Exhibit 3, on items 7A-1 and 2, are the respective amounts of commissions payable to Bertholon-Rowland in its capacity as broker and the service allowances payable to Bertholon-Rowland in its capacity as an administrator.

Q. What would those payments represent, what services would be performed for those payments?

A. Well, commissions are payable with respect to ongoing sales activity. The Bertholon-Rowland organization conducts the continuing enrollment solicitation among members of the New York State Bar Association for participation in the plan and some of [356] it by mail, some of it involving personal contact. And they handle all of the promotional and sales activity, including putting out sales promotional literature; designing literature that is used for solicitation activity in the case. And they get compensated through commissions on the business produced as well as renewal commissions on the premium payable for old business.

The administrative allowance is payable with respect to their services in connection with processing premium remittances from insured members. And that also includes the mailing of premium billings to the insured members. And the distribution of the dividend credits to insured members as credits on premium bills.

Q. I take it then that Bertholon-Rowland acts both as a broker and an administrator on this plan?

A. That's correct.

Q. And am I reading Exhibit 3 correctly to say that the total compensation for both brokerage activity and administration for this particular year was 9.1 percent of premium?

A. That's correct.

Q. I direct your attention to Exhibit 298, also [357] Exhibit Roman III on 298, and ask you to point out to us where the compensation to Bertholon-Rowland is reflected on Exhibit 3.

A. Well, again, we have a rearrangement of the sequence of presentation but in the breakdown of balance, item B, Subitems 1 and 2 are the respective counterparts for the policy year ending in 1980 of the amounts shown in the earlier exhibit for the preceding policy year.

Q. So that reflects the 9.1 percent we just discussed plus 10.5 percent for the year '79, 80?

A. That's correct. Now, I have to comment that that 10.5 percent figure includes some amounts referred to in footnotes on that exhibit; some of which were amounts that were paid as adjustments of amounts calculated in previous years.

Q. In the retrospective adjustments of amounts that had been determined for previous years that were incomplete? Those are the two footnotes indicated there?

A. That's correct.

Q. Are the dividends for the New York State Bar for these two years reflected on this page?

A. Yes. The dividend is shown as line 5 and this is the aggregate of the amounts paid as dividends [358] to the individual policyholders.

Q. That was 43.5 percent for '78, '79 and the 39.7 percent for '79, 80?

A. That's correct.



Q. Directing your attention to Exhibit 299, would you point out that same information for us, please, the payment to Bertholon-Rowland and the dividend.

A. All right, Exhibit 3, under the breakdown of balance, Item B, Subitems 1 and 2, and the figure for the policy year ending in 1981, commissions is \$452,000, administrative allowances, \$116,000, and for some reason there is one less decimal place in the percentage figures shown in this exhibit than there had been in the others but it is clear that the amount is in the neighborhood of 9 percent of premium for combined commissions and administration allowances.

Q. And the dividend?

A. And the dividend was \$2,792,000, 44 percent of premium.

Q. Approximately how did the gross premium rates on the New York State Bar plan compare with the Endowment plan during the years in issue?

A. In general, the gross premium rates are somewhat comparable but there are some situations [359] where they are higher than the American Bar plan and others where they are lower. The situation or the subject is addressed in the Exhibit 627 report, Exhibit Roman X-A near the end of the report, which contains some comparisons, and those comparisons show, for example, that there are some situations where the premiums charged to members for the New York Bar plan were lower than the American Bar plan premiums. A case in point would be at age 40 for an individual with \$100,000 of insurance, where the premium charged for the American Bar plan was \$500, the premium charged for the New York State Bar plan was \$448. For the policy year ending in 1980. And then effective in December, 1980 for the new policy year that premium rate was cut to \$408. So the gross cost, the gross premium cost of the American Bar plan was higher than the gross premium cost of the New York Bar plan at that time.

Q. Mr. Moran, next I want to show you what has been marked as Exhibit 301 and as Exhibit 1201-A, and ask you to identify them.

A. Exhibit 301 is a copy of the financial experience report to the broker administrator with respect to the experience on the group life plan for the members of the Institute of Electrical and [360] Electronics Engineers, commonly referred to as the I triple E.

Q. How big a group is the I triple EEE?

A. The insured group contains some 30 to 40,000 members, I believe.

Q. 30 to 40,000 insured lives in the group?

A. Insured lives.

Q. What's the practice of this group with respect to dividends?

A. New York Life disburses the dividend to the trustee of the IEEE insurance trust, which holds it pending instructions from the administrator for distribution or for distribution for disposition. Let me withdraw that comment. I can make it a simpler description if I start over.

When New York Life completes the determination of the amount of the dividend, we notify the trustee and the administrator of the amount of the dividend that is being determined. They respond "hold the money as an advanced premium deposit pending instructions. At some point we'll tell you what to do with it." They then calculate the amount that is to be distributed as a credit to the individual insured members of the IEEE at the next semiannual billing date. The policy anniversary is September 1. The [361] next semiannual billing date is March 1. When the administrator prepares the billing notices to the IEEE members for the remittances due on March 1, they reflect a credit for the allocated share of the dividends on the case, usually determined as a percentage of the premiums for the preceding policy year.

In some instances, the credit may be equal to the entire amount payable by the insured member, so that the member receives a notice that nothing is due, the dividend is distributed as a complete offset to the premium contribution required.

Q. How would the net cost during the years in issue of the members of the IEEE group compare with the costs to Endowment members of the same amount of coverage?

A. Very favorably.

Q. Favorably with respect to whom?

A. It's very favorable to the people insured under the IEEE plan.

Q. And why is that?

A. Dividends have been consistently high, in the neighborhood of 40 to 50 percent, and I believe they have exceeded 50 percent at least once if not more. Premium rates have been roughly comparable. [362] The premium rates have been reduced two or three times since the early 1970s, so that the gross costs to the member compare favorably with the American Bar plan and with dividends in the 40 to 50 percent plan, the net costs compare even more favorably.

Q. Do Exhibits 301 and 1201-A reflect the dividends for the years in issue?

A. Yes.

Q. What were they?

A. For the policy year ending August 31, 1979, the dividend was 56.6 percent of premiums for that policy year, and for the policy year ending August 31, 1981, the dividend was 52.3 percent. Exhibit 1201-A also shows the figures for the intervening year ending in 1980, where the dividend was 53.7 percent.

Q. Let me direct your attention to the second page of each of these two exhibits and ask you whether they reflect the compensation to Smith Sternau for their work in this program?

A. Yes.

Q. Let's just by way of example look at Exhibit 301. Would you explain what the compensation to Smith Sternau consists of and what work was done by Smith Sternau to earn that compensation?

A. With respect to commissions, in its role as [363] a broker, Smith Sternau had full responsibility for the ongoing promotion and enrollment solicitation of the program, publicity, mailings to individual members, encouraging existing insured members to upgrade their coverage, participation in meetings with the IEEE organization to some extent. It was a sales function. And those commissions of \$578,000 represented the sum of first year commissions at the rate of 15 percent on first year premium for new coverage, renewal premiums at 5 percent on the remainder of the premium. The service allowance shown is for performing all of the underwriting processing, certificate issue processing, maintenance of enrollment records, premium notice mailings to insured members, processing of contributions received from members toward their premiums, handling all general service work with the insured members, including transmittal of notices back and forth, communications with New York Life to provide us the data we needed for actuarial purposes, etc.

The compensation payable to Smith Sternau for performing those services for this policy year ending in 1979 was \$12 per year per insured member, which worked out to \$435,000, and obviously that indicates there were about 36,000 members insured [364] during that year. The compensation represented 4.3 percent of premium for administrative services.

Q. Thank you.

MS. CARPENTER: At this time I offer Exhibits 301 and 1201-A in evidence.

MR. MARKHAM: No objection, Your Honor.

THE COURT: Admitted.



(The documents referred to, previously marked Plaintiff's Exhibit Nos. 301 & 1201-A for identification, were received into evidence.)

MS. CARPENTER: And I also move the admission of Exhibits 297, 298 and 299.

THE COURT: Are those stipulated as well?

MR. MARKHAM: No objection, Your Honor.

THE COURT: Okay, 297, 298, 299, 301 and 1201-A are admitted without objection.

(The documents referred to, previously marked Plaintiff's Exhibit Nos. 297 through 299 for identification, were received into evidence.)

BY MS. CARPENTER:

Q. Mr. Moran, next I am going to hand you Exhibits marked 309 and 302.

Can you identify Exhibit 309?

[365] A. Exhibit 309 is a copy of a worksheet prepared by one of the people in New York Life's Association group division to recapitulate the basis on which the factors were to be determined for computation of the service fees payable to the Smith Sternau organization as administrator of the group insurance program sponsored by the trustees of the Engineering Association's Insurance Trust for the policy year 1978 and '79.

Q. Can you identify Exhibit 302?

A. Exhibit 302 is the counterpart worksheet used to determine the service compensation to Smith Sternau on the same EAIT group life plan for the policy year beginning October 1, 1980.

Q. Were forms similar to this used to calculate the compensation that we just discussed on the IEEE plan?

A. I won't say they were used to calculate the compensation. They were used to document and record the determination of which factors in the array of factors in our compensation scale were applicable to a particular case for a particular policy year.

Q. You should forgive my imprecise question, was a sheet like this one filled out for IEEE?

A. Yes.

[366] Q. And I see a number of figures circled here, how is it determined which one of these figures to circle?

A. An individual familiar with the operation of the administrative functions on each case notes which of the functions are actually currently being performed by the administrator with respect to each plan; and he checks off those that are and adds up the factors that pertain to those functions that the administrator is performing. The amount of compensation that will be payable is the lesser of the amount determined by applying the dollars per insured member factor or the percentage of premium factor.

Q. How does the percentage of premium factor come in? I note it says maximum percentage of premium.

A. What that means is that even if our scale calls for payment of \$14 per year per member for coverage under a particular plan, we still will override that scale provision if necessary to keep the compensation that is payable from exceeding 12 and 1/2 percent of premium.

Q. Did the compensation payable during years in issue typically reach the maximum percentage of premium on your professional association group cases?

[367] A. It did not come close to the maximum on any of our professional association group life plans.

Q. Was this the standard scale used to calculate compensation for administrators of professional association groups during the years in issue, as referring to Exhibits 309 and 302?

A. The factors shown on these two exhibits are the mainstream factors applicable generally. There were certain situations where the functions were performed by an administrator on some kind of a modified basis, which called for the regular factors to be overridden in a fashion that generally would have produced reduced



compensation, taking into account some functional activities that were saved by the methods used in a particular case

Q. Mr. Moran, did you, at my request, calculate what the Endowment would have been paid had it been a third party administrator on its plan during the years in issue?

A. Yes.

Q. And could you give me those figures for 1978, 1979?

A. I left them in my briefcase.

Q. Could you excuse us one moment, Your Honor?

A. For the policy year ending in 1979 the [368] compensation payable on the same scale that was illustrated on the worksheet that has been introduced as Exhibit 309 would have been \$466,792, representing 6.46 percent of premium for that policy year on the American Bar Endowment case.

For the policy year ending in 1980, compensation would have been \$460,556, representing 6.04 percent of premium.

On the revised scale of factors applicable to the 1981—the policy year ending in 1981 for the Engineering Association case was illustrated on the worksheet introduced as Exhibit 302, the compensation hypothetically payable on the American Bar Endowment case would have been \$519,192, 6.63 percent of the premium.

Q. Mr. Moran, suppose that during the years in issue the American Bar Endowment had come to you and said, "We have found a third party administrator who will administer our plan for less than the standard factors used by New York Life." Would you have entered into an association with that third party administrator to administer the American Bar plan?

A. We would not have let the fact that they were interested in performing services for less than our normal standard scale have prevented us from [369] working out an arrangement to do business with them. There were certain technical requirements prescribed by New York insurance law that would have to be dealt with in order to arrange for determining the compensation on a mutually acceptable basis, but we had experience of having worked out arrangements to do so in other situations, so we would have been willing to deal with them, subject of course to a determination that they be able to provide adequate service to our satisfaction and confirming that their interest in doing so was acceptable to the American Bar Endowment.

MS. CARPENTER: Your Honor, I move the admission of Exhibits 302 and 309.

MR. MARKHAM: No objection, Your Honor.

THE COURT: They are admitted.

(The documents referred to, previously marked Plaintiff's Exhibit Nos. 302 & 309 for identification, were received into evidence.)

MS. CARPENTER: Thank you, Your Honor.

\* \* \* \* \*

[380] JOSEPH MORAN  
having been previously sworn, testified as follows:

DIRECT EXAMINATION

BY MS. CARPENTER:

Q. Mr. Moran, yesterday you mentioned that you first became involved in the American Bar Endowment case in 1953. Were you involved in the case continuously after that?

A. To one degree or another, almost continuously.

Q. Until 1981?

A. Up until May of 1981.

Q. Back in the 1950's when the Endowment entered into the group contract with New York Life, was the Endowment paid anything for entering into the contract or providing the group?

A. No.

Q. During the years in issue, approximately how many professional association groups were insured by New York Life?

[381] A. New York Life insured about 50 professional associations. A large number of those associations were under a multiple association trustee plan that we discussed yesterday. We had actually about 15 separate cases for the purposes of managing our business.

Q. How much professional association life insurance was in force during the years in issue?

A. During the neighborhood of \$10 Billion face amount of life insurance.

Q. Has the ABE group life plan always contained a large margin of dividends?

A. Yes.

Q. Would that margin have been lower if fund raising had not been the goal of the endowment?

A. Very likely, yes.

Q. Yesterday we were talking about the dividend formula and I asked you what was the largest element in the ABE's dividend formula and you said that as to deductions, claims were the largest element, is that correct?

A. That's correct. The largest numbers that get into the dividend calculations are, of course, the premium numbers, which are the main additive item. The other items are subtracted from premiums and the dividend is a remainder of premiums.

[382] Q. And yesterday we also talked about the New York State Bar Plan?

A. That's right.

Q. How much insurance was available to members of the New York State Bar Association during the years in issue?

A. During this period I believe the maximum amount of insurance was about \$250,000.

Q. Now, switching gears for a minute, in the American Bar Endowment Plan, do you know how many lawyers with billing addresses in New York State who were enrolled in the American Bar Endowment plan during the years in issue?

A. According to the information supplied by the Endowment for use in our calculation of premium taxes, the New York lawyers accounted for about 8.8 percent of the business in force on the American Bar case for a period in which the enrollment was in the neighborhood of 44,000 members on the Endowment's plan. That would mean that there were just under 4,000 New York people insured on the Endowment plan.

Q. What state had the largest enrollment in the Endowment Plan?

A. New York.

Q. Is New York Life or was New York Life during the years in issue contractually obligated to pay the Endowment a dividend?

\* \* \* \* \*

[387] Q. Mr. Moran, I'm going to show you an exhibit that's been marked as Exhibit 1173. Can you identify this document?

A. This is a copy of New York Life's report to the insurance committee of the American Optometric [sic] Association on the financial experience for the policy year ending November 30th, 1980, on the group life insurance plan sponsored by the AOA as group policyholder.

Q. Now, at this time was there an administrator on the AOA plan?

A. Not at this time.

Q. Were any payments made to the AOA for administration?

A. Not by New York Life.

Q. Was there a broker or an agent?

A. Yes, during this policy year there were three different brokers involved. The original broker who had been designated by the AOA when the group policy was originally issued in 1956 had remained designated to receive renewal commissions with respect to a portion of the premium on the case.

And then in 1977 the AOA had arranged for designation of a brokerage firm to assume responsibility for ongoing solicitation and promotion of the plan and that broker was entitled to receive commissions on first year premium for new [388] business generated after that date, and also to receive renewal commissions to the extent that there was growth in the amount of renewal premium on the case above the level that had been in force at the time the new broker was designated.

Unfortunately that broker early in 1980 became unable to continue in the role of broker and during 1980 there was another brokerage firm selected as its successor and that new brokerage firm was entitled to commissions with respect to new business generated beginning August 1, 1980.

Q. Now, are the commissions for all of these brokers reflected in Exhibit 1173?

A. The commission figures shown in this exhibit represent—

Q. Mr. Moran, do you want to direct our attention to where you are?

A. I'm on Exhibit 3.

Q. Which is the fourth page of this document?

A. The fourth page of this exhibit. And, the figures shown for the current year as commissions because of some of the unusual circumstances that prevailed at the time represent the amount which would have payable for this policy year if there had not been a change in the brokerage arrangements during the year.

Q. That would be the 3.1 percent figure?

A. The 3.1 percent factor represents what would have [389] been paid. We actually paid somewhat less than that because of the hiatus between the termination of one broker's activity and the assumption of responsibilities by the new broker.

MS. CARPENTER: Your Honor, I move the admission of Exhibit 1173 into evidence.

MR. MARKHAM: No objection, your Honor.

THE COURT: It's admitted.

(Plaintiff's Exhibit 1173 was received into evidence and made a part of the record thereof.)

BY MS. CARPENTER:

Q. Mr. Moran, with respect to the Ontario Medical Association, which we discussed yesterday, how large a group is that?

A. During the years of issue, there were some 8,000 members insured for a total amount of insurance somewhat in excess of a billion dollars.

Q. And I think you told us yesterday that that's a self-administered plan?

A. Yes.

Q. And that the organization returns more than the dividend back to its members?

A. That's correct.

\* \* \* \* \*

[395] [Moran—Cross] A. We assess charges for underwriting, which vary according to whether we do the entire review of the application papers or whether there is



a preliminary screening performed by some other organization. With respect to general service to insured members, preparation and transmittal of communications to members, mailing notices to members, handling correspondence for members with respect to changes in beneficiary designation, name changes.

There there's again a distinction between the charges that are assessed if New York Life performs those services versus the charges that apply if somebody else performs those services.

Maintenance of individual enrollment records with respect to the insured members, the charges are higher if we do that ourselves than they are if somebody else is doing it under our supervision. The collection of remittances from insured individuals to be applied toward payment of premiums by the association, again there is a charge that is larger for that collection function if it is performed by New York Life than if it's performed by another organization.

All of those are costs which would have been higher—for which the expense charges would have been higher if New York Life had been providing the services directly.

Q. And in other words, if New York Life or an independent broker-administrator had performed all of the services [396] and functions you just mentioned, which were undertaken by the endowment staff, item six would have been substantially higher and the dividend balance would have been substantially lower?

A. Well, the expense charge would have been substantially higher. The depletion of the dividend which would have resulted, would have been substantial in dollars for a relatively small percentage of the amount of the dividend.

I think I quoted yesterday a figure of about—somewhere between four and five hundred thousand dollars as the amount that we would have paid an independent

broker-administrator for performing an array of administrative functions. And had we done so, the depletion of the dividend that would have resulted would have been only about one-ninth of the dividend. In other words, of that \$4,278,000 of refund for this policy year, which was dividend plus a couple months' interest on the dividend, almost 90 percent of it would still have been payable even if New York Life had been using an outside administrator to provide the services that the American Bar Endowment provided itself.

Q. And I believe that on direct examination you testified that New York Life did not pay compensation to the Endowment for performance of services. Isn't it true, however, that New York Life paid a dividend to the Endowment, which was, in fact, enhanced or larger, by reason of the [397] fact that the Endowment was performing those services, rather than someone else?

A. I think you're looking at it in reverse. As we perceive it, you start with the normal presumption that a group policyholder is free to perform certain functions as a policyholder on its own behalf, do the functions itself, in which case New York Life's charges for supervision of the performance of those functions is at the minimal level that's illustrated in this exhibit.

On the other hand, we make available to group policyholders, and it's not just professional association groups, there are a number of other policyholders for whom New York Life performs extra services above the minimum level and where we provide extra services to a policyholder, we assess extra charges in the calculation of dividends to recognize the extra expenses that we incur for providing those services, whether we do them ourselves or whether we engage somebody else to do them and pay that third party for performing the services.

When that happens, the expense charges are increased and the dividend is depleted. So, in the context of your question, a dividend margin for refund of \$4,200,000. would have been depleted by somewhere in the neighborhood of \$400,000 or \$500,000 if the Endowment had requested that New [398] York Life arrange for providing those services through an independent administrator.

Q. How many other professional association groups did New York Life underwrite during this period in dispute, 1978 through '81?

A. We had about 15 professional association group life cases.

Q. Which, if any of these other groups performed the same scope of administrative services which the Endowment performed?

A. In general, the Ontario Medical Association performed substantially the same services on its plan that the American Bar Endowment performed on its own behalf on its plan.

With some exceptions, the American Optometric Association also performed administrative services on its own behalf, comparable to those performed by the American Bar Endowment.

Q. In Item four on this exhibit, Exhibit 5 through Exhibit 1109,—excuse me, Item seven, contribution to surplus, how is that computed? In other words, how is the 1.1 percent and .08 percent determined?

A. Well, the percentage that shows up in the exhibit is just the ratio of the dollar amount to the premium.

\* \* \* \* \*

[401] [Moran-Cross] Q. In constructing group term life insurance rates, must an actuary also make assumptions about the expected mortality of members of the group?

A. Usually is required to make projections of expected mortality as distinct from assumptions. You can make a variety of assumptions and among those you probably will have to select something to be used as a projection or prediction.

Q. How would a group of attorneys be characterized or rated from a mortality standpoint?

A. Well, in an instance like this group, the American Bar Endowment, we would be relying primarily on our actual experience with respect to mortality and morbidity, in the group that we already insured as a primary reference point in projecting future mortality experience.

If we were developing a premium rate for a brand new group insurance risk for which we did not have a counterpart of such actual experience, we would start with a standard reference mortality table and apply adjustments on experience available from other sources that indicated the extent to which lawyer mortality differed from other types of active working groups.

Q. In general, how would you expect lawyer mortality to differ from that of the general working population?

[402] A. I think in general, we would say all other things being equal, the mortality on lawyers might be some 20 percent or so lower than the general mortality on the employed population as a whole.

Our actual mortality experience on our American Bar Plan and the New York Bar Plan show that if we look at the mortality experience on lives that have been underwritten for medical acceptability, we are able to achieve significantly lower mortality, just as we are for any other group that we underwrite on a basis of underwriting selection.

Q. What were the medical underwriting requirements for the Endowment plans during the period 1972 to June 1st, 1981?



A. Well, in general, members were required to submit a brief statement of health that included about half a dozen questions, designed to elicit information likely, — of a nature that was most likely to indicate the presence of a significant condition that would indicate significant substandard mortality.

As an exception to the general rule, for enrollments in plan A of the American Bar Endowment Program, there were general liberalizations that said members below age 40 can enroll for plan A without submitting any evidence of insurability.

\* \* \* \* \*

[433] [Moran—Cross] A. I don't recall a specific written document that addressed that question as you have done so. There are references in the report that was admitted as Exhibit 627 to the fact that the potential for a charitable contribution deduction with respect to a portion of the amount paid by an ABE member for insurance under the plan clouds and fuzzys up the question of a head-to-head comparison of net costs under this plan, which are the gross outlays, with the counterpart net cost under any other plan.

I also had made oral statements at one, and I don't know which, of the three American Bar Endowment Insurance committee meetings that I attended along the lines that the whole American Bar Endowment plan was designed with the concept that the members would pay something more for their insurance than what they would get it for at the lowest [434] available net cost, and that there had to be a limit in the mind of the American Bar Endowment member as to what he could tolerate, or what he was willing to go along with in the interest of organizational support as to the magnitude of that extra payment that he made.

We were dealing in an environment where the total outlays for life insurance were getting to be much larger than they ever had been before. And a fifty percent excess cost on a thousand dollar premium was a lot more significant in the mind of an Endowment member than a fifty percent excess cost in the mind of an Endowment member who was only paying fifty dollars a year for insurance coverage.

And that the growing gap between the cost of insurance under this plan and the cost of insurance under other plans, and the fact that it was a larger percentage of a larger dollar amount was going to give them problems, and was going to give them increasingly greater problems with the passage of time.

I don't know which meeting I expressed that idea at. I attended three meetings of the insurance committee.

THE COURT: Unless you have an immediate follow-up to that I would like to call lunch right now.

MR. MARKHAM: Just one, Your Honor.

\* \* \* \* \*

[480] [Moran—Cross] A. And the rationale in 1980 was that the competitive environment was changing so rapidly that the likelihood of maintaining enrollment growth patterns and persistency patterns without a response to that competitive environment was such that you would sustain some deterioration in persistency and deterioration in new enrollments if there was no change in the pricing.

And for illustrative purposes we assumed that the changes being recommended would be sufficient to restore the persistency and new enrollment pattern that had previously been projected on the basis of prior experience.



Q. Was the recommended rate revision graded in such a manner that the largest percentage of—or an increasingly large percentage reduction was applied to those enrollees in—excuse me, the older age brackets, and for the higher amount of insurance plans under the ABE series of life insurance plans?

A. The reductions in premium rates for each plan were uniform in all age brackets. But as compared from plan to plan the reductions were relatively highest for the richest plans and graded off to no change in rates for the basic Plan A.

The purpose of structuring the reduction in this fashion was to respond to the pattern of the competitive [481] marketplace under which other companies in their individual term insurance marketing were offering scales of premium rates that decreased even more sharply than we felt appropriate for the American Bar Endowment plan.

Again, looking back at the pattern illustrated in Exhibit 8 or Exhibit 10, the difference in price for a forty-year-old individual between the man who buys \$50,000 of life insurance and the man who buys—

Q. Excuse me. Which exhibit are you referring to now?

A. Exhibit 10. In the age forty column in Exhibit 10, the top half of the table, the man age forty buying \$50,000 of life insurance pays a premium that's some forty-four percent higher than the individual who buys \$200,000 as a preferred risk.

That spread is so great that we saw no way of matching it in a plan like the American Bar Endowment plan where we are not differentiating between preferred risks and standard risks and moderately substandard risks. All acceptable lives are charged the same premiums. In that context there's no way that we could have that steep a

gradation of premiums from plan to plan, but we did feel that we had to respond at least in part to the competitive market pattern.

\* \* \* \* \*

[494] [Moran—Cross] A. So, in effect we have the same spread between expected claim costs and the identified premium rates segment for the AD&D portion that we have for the remainder of the case. It's roughly proportionate.

Q. I would like to place your last answer within the context of Exhibit 627 on—do you still have a copy of that? On Exhibit 10-A on page 0079 of that exhibit?

I think the exhibit indicates, and you previously testified that the New York State Bar Association plan did not have AD&D but the Endowment's plan does have such benefit.

Based on the figures you just testified to, what would the cost change be on the bottom line of the Endowment's block of data, their cost per thousand attributable to the AD&D benefit? I think these are semi-annual rates.

A. Well, if we want to go back to the column age forty to forty-four that I have used in previous comments, the bottom line figure in the New York State Bar block is an annual net cost to the insured of \$2.24 per thousand.

I estimate that that figure would rise to about \$2.50 per thousand if the plan were liberalized to include accidental death benefit coverage, and if the experience on that accidental death benefit coverage were comparable to [495] what is it on the American Bar Plan.

The gross premiums would probably go up by about \$40—somewhere between 40 and \$50 per year for a \$100,000 of accidental death benefit coverage. Claim costs would be somewhere between \$25 and \$30 per year per \$100,000.

It still would be a very substantial gap between that the cost and the cost on the American Bar plan.

\* \* \* \* \*

[572] EDWIN P. BROOKS  
was called as a witness by counsel for Plaintiff and, having been duly sworn by the Trial Judge, was examined and testified as follows:

DIRECT EXAMINATION

BY MS. CARPENTER:

Q. Mr. Brooks, would you state your full name and address for the record, please?

A. Edwin P. Brooks, 77 Cedar Place, Wayne, New Jersey.

Q. Mr. Brooks, do you also go by Pat Brooks?

A. Yes.

Q. And what is your current occupation?

A. I am a group insurance consultant.

Q. For what company?

[573] A. I currently have a contract with the Continental Insurance Company in New York.

Q. Was there a time you were with the New York Life Insurance Company?

A. Yes, from 1951 until 1980, I was employed by the New York Life.

Q. Would you summarize briefly your career at New York Life, what you did, and what your position was?

A. Surely, For most of the time that I was with the New York Life, I was in charge of their group national accounts operation. This involved an organization of some twenty people that would report to me, and they were divided into four units of five apiece. Sometimes the number varied a little, but basically that was about it. Three of these units were located in New York City and

one was located in San Francisco. Each one of these units would be assigned a group of national account cases to represent New York Life.

Now, a national account case was simply identified as a case involving a half million dollars or more of premium. Incidentally, I believe that since I left the New York Life that figure may have moved up to a million dollars or possibly even more, I am not aware.

A national account case could be any kind of a group insurance case. It could be an employer-employee case. A good [574] example would be the Kaiser companies, Southern Railway, World Bank. It could be a public employee case. We handled the State of Washington and the State of Colorado cases.

It could be a trade association case, which would be the Professional Insurance Agents, would be a good example. The National Tire Dealers would be another good example, or it could have been a professional association case, such as the American Bar.

Along about sometime between 1970 and 1975, the professional association cases were taken out of this category and handled by a different group of people, with the exception of the American Bar case. The American Bar Endowment case was always handled by myself and one of the units that reported to me.

Q. Then why was the American Bar case the exception?

A. At the time that the New York Life moved them out and formed a separate unit, the company felt that there was going to be a rapid expansion in the professional association group field that would warrant special attention. By rapid expansion I mean in the number of cases that the New York Life might sell and in the size of those cases, etc., and so it was merely to focus additional sales and service talents of the company on those cases that they pulled it out.



Q. Was it also because of your personal relationship [575] with the Board and the Administrator of the Endowment?

A. The reason that they left the American Bar Endowment case with our National Accounts Unit rather than pulling them out was that myself and the unit had had this long standing relationship. We understood the case. It was not too dissimilar from the other cases that we were already handling, and they felt for that reason it would be in the best interests of New York Life to leave them with them, yes.

Q. Would it be proper to describe your role with respect to the Bar Endowment case as an Account Executive?

A. Yes.

Q. Were you the primary contact with the Board of Directors on behalf of New York Life?

A. Yes. The way in which we would function, we were primarily concerned with the sale and servicing of large group business. In the large case area, we had certain contacts with the American Bar Endowment as with our other large cases. Basically these contacts would fall into about five or six categories.

One would be discussion of contract changes. Another would be discussion of benefit changes. Another would be renewal rating. A very important one was each year we would give a financial report to the American Bar Endowment, as we did to our other large policy holders.

[576] Another category would be any routine service problems. If there was a problem related to claim payment or a problem related to premium collection, we did not handle premiums, and my unit did not handle premiums or claims, but if problems arose with the New York Life, we would step into the picture.

So almost all of the executive contact between the New York Life and the Endowment would come through me and my unit through the Endowment, and from the Endowment Board through me and my unit to New York Life.

Q. How long did you fill that role on the Endowment case?

A. Twenty-five years.

Q. How many board meetings did you attend, Board of Directors of the Endowment meetings, during that twenty-five years?

A. During most of those years the Endowment had four meetings, I believe, and I went to about ninety percent of them.

Q. Mr. Brooks, what is your understanding of the purpose of the group life program to the American Bar Endowment?

A. To raise funds for charitable purposes in the field of law.

Q. Mr. Brooks, I want to show you what has been previously marked as Exhibit 274, and ask you if you can identify it?

A. Yes.

Q. Would you describe this, please?

[577] A. This is a letter that I wrote to Judge Craig to advise the Endowment of my retiring from the New York Life.

Q. Mr. Brooks, in your letter you refer to the fact that during your twenty-five years on the Endowment case, \$33 million has been paid to beneficiaries of the deceased Endowment members, and that \$35 million in dividends had been paid on the life program. Where did you obtain those numbers?

A. Each year we gave the American Bar Endowment a very detailed and complete report of all of the financial aspects of their program with the New York Life. One of



the items on that report would be the current year and the cumulated paid claims. Another item would be the current and accumulated dividends. Both of these figures came from the last one of those reports that had been prepared by me.

Q. Now, I would like to direct your attention to the dividends that were paid on the Endowment case while you were at New York Life, and will ask you some questions about those dividends.

A. Yes.

Q. Were those dividend payments for sponsorship or endorsement of New York Life's Group Life Program with the Endowment?

A. No.

Q. I am sorry?

A. In my opinion, the word "dividend" is really a [578] misnomer in this kind of a case. It is very commonly used because mutual companies determine the amount of return of unused premium by use of a dividend formula. Actually a dividend on this case is really a return of unearned or unneeded premium.

Q. Is the amount of the dividend negotiated between the policy holder and company?

A. No, it is not. The amount of the dividend is solely the result of the application of the New York Life's dividend formula to the particular case. It is in no way negotiable.

Q. And is the dividend a payment for any sort of services rendered?

A. No, it is not.

Q. Is it a payment for bringing a group to New York Life?

A. No.

Q. Is it a payment for assumption of underwriting risk?

A. No.

Q. Is it a payment of any sort of entrepreneurial fee or profit?

A. No. Again, I think it ought to be clear that it simply is a return of premium that was not needed, no more, no less.

Q. While you worked at New York Life, did your group pay any of your large account cases for sponsorship or endorsement or for bringing their groups to New York Life?

A. No.

[579] Q. Why was that? Wouldn't you get more business if you did that?

A. Pardon.

Q. Wouldn't the New York Life have obtained more business if it had paid people to come to it?

A. Well, in most of the group business of the New York Life it wouldn't even be a consideration. The cases that the New York Life obtained were either sold directly by the New York Life, or they were sold by agents of the New York Life or by brokers, one or the other. The only compensation from the New York Life for obtaining business would be paid to an agent of the New York Life or to a broker, not to a policy holder.

Q. These would be people who would have to be licensed under state law?

A. Oh, surely.

Q. And why wouldn't you pay a policy-holder?

A. There would be no need for payment to a policy-holder. In the rare instance where you might have something of that nature, it was against the policy of New York Life to do that. I am referring to a group creditor insurance, where, as I understand it, some companies did compensate group creditor policy-holders. New York Life never did while I was with them.

Q. Do you know why New York Life never did that?

A. They considered it a questionable practice from an [580] ethical viewpoint, and it was against the company's policy to do that.

Q. Mr. Brooks, can you explain, referring now to the administration of the group policy, explain the similarities and difference between the ABE plan administration and the administration of the employer-employee group?

A. Surely. As I mentioned earlier in the testimony, we were handling professional association cases, trade association, employer-employee, public employer groups. In all of those types of groups the administrative functions to be performed are quite similar.

The big difference between a professional association case and the others is that in a group life case with an employer, for example, the employer is paying all or part of the premium.

In a professional association case, the premium comes from contributions from the insured people; therefore, the biggest difference between these types of cases is that on the employer-employee case the enrollment procedure is much simpler.

In a professional association case, the only practical way of enrolling people in the plan is through the mail, and it takes a big and continuing promotional effort through the mail to get the enrollment that you need in a professional case.

\* \* \* \* \*

[607] [Brooks—Cross] Q. Would you say that the Endowment staff performed a full range of administrative and marketing functions in association with the marketing of the life insurance program?

MS. CARPENTER: I object to that question. What does Mr. Markham mean by a full range of administrative and marketing functions? I think we need a definition of that before the witness can answer the question. Compared to what?

THE COURT: If the witness is unable to understand the question, he is competent to tell us.

THE WITNESS: I would eliminate the marketing part of the question and say that they were certainly competent in the full range of administrative responsibilities that they had. As I mentioned earlier in my testimony, the functions that were performed by the Endowment's office, the processing of claims papers and premiums and keeping of individual records, the screening of medical, are the same type of things that would be done on any group life case that we had. An employer, for example, would have an employee benefit department that would be performing those functions. Take the word "marketing" out. I don't look at the Endowment's office as a marketing operation. It was solely confined to the promotion of the Endowment product of benefits with members of the American Bar Endowment to [608] attract them to enrollment in the plan.

Q. Does New York Life perform any functions with respect to the preparation of promotional material used in the Endowment's promotion of its life insurance program?

A. Most of the time we reviewed the materials after they had been prepared by the Endowment office. There were a few occasions over the years when New York Life group sales promotion people made some suggestions which were then developed by the Endowment's office.

Q. Did you deal personally or did anyone under your supervision deal with anyone specifically on the Endowment staff regarding the preparation and review of promotional documents?

A. Yes, we dealt with the various Endowment staff people that were involved in that activity over the years, and, as I mentioned, New York Life had the Group Promotion Unit that worked through me to the Endowment.

Q. Would you feel qualified to evaluate the quality of the promotional materials prepared by the Endowment in



comparison with those generally disseminated in the insurance industry to promote similar types of insurance plans?

A. I have an opinion on it, yes.

Q. Do you feel that you have enough background to express an opinion? \* \* \*

\* \* \* \* \*

[610] [Brooks—Redirect] A. No, the professional association cases that are listed here, as well as others that the New York Life had that aren't listed, all returned part or all of the dividends to the members.

MS. CARPENTER: No further questions, Your Honor.

MR. MARKHAM: I have no recross, Your Honor.

MS. CARPENTER: Does Your Honor have any questions of Mr. Brooks? He is the last gentleman here from New York Life Insurance.

THE COURT: I don't have any questions. His testimony was more direct than cross and was very enlightening.

MS. CARPENTER: May he be excused?

THE COURT: Yes. Your testimony was very enlightening.

MR. GREGORY: If Your Honor please, we call William T. Holt.

Whereupon,

WILLIAM T. HOLT

was called as a witness by counsel for Plaintiff and, having been duly sworn by the Trial Judge, was examined and testified as follows:

#### DIRECT EXAMINATION

MR. GREGORY: Your Honor, we intend after qualifications to offer Mr. Holt as an actuary expert in the field of group health and accident insurance. In order to save time, I have [611] asked Mr. Holt to summarize his

educational background and professional designations. He has made some notes, and I would ask permission for him to read from them at this time.

THE COURT: That is fine.

THE WITNESS: I received a Bachelor's Degree in 1961 from Southwestern College with a major in mathematics.

I am a Fellow in the Casualty Actuarial Society and received that designation in 1970. This is equivalent to a fellow in the Society of Actuaries for Life Insurance. In achieving that designation you have to pass a series of nine examinations, which covers all aspects of various casualty insurance, including health insurance, and primary emphasis then, of course, is on rate making, on reserve methods.

I am also a member of the American Academy of Actuaries, and this includes members of other professional actuarial organizations. This basically has a requirement of both passing examinations of those organizations and some credible work experience in the actuarial area.

My work experience, from 1961 to 1968 I was employed with Travelers Insurance Company in their Group Actuarial Department, working primarily on group life and health insurance. Most of that time I spent in the experience rating area, working with large employers with five hundred employees or more.

[612] A few basic functions that were performed in that area were determining retrospective refunds on large groups and developing the required premium levels to be charged on each of those groups in the next policy year.

My last year at Travelers Insurance Company was spent on the actuarial research area, where our primary emphasis was upon developing new rating procedures and making recommendations along that line, and secondly, evaluating the rate levels with the smaller groups which the Travelers sold and which were pooled for experience.



In 1968 I joined Mutual and United of Omaha, where I have been employed since 1969.

Initially my primary responsibility was in the group actuarial area. It was much broader than the responsibilities I had in Travelers and included all aspects of the actuarial area as pertained to the group life and group health.

Just in summary, some of the functions were to determine the premium refunds, determine the renewal rates to be charged for the groups, evaluating our manual rates, determining what inflation factors were, reserving methods.

I also assisted in the development of new products and developing rates for those products.

In 1974 my experience expanded to include the annual statement area of the group operation. The other significant [613] change in my responsibility took place in 1982, when we had a reorganization of the group operation. I was named Vice-President of Risk Management.

As part of this reorganization, the responsibility of the annual statement was transferred to our financial area, and risk management basically included the group actuarial and group underwriting areas, where underwriting was involved more in the risk selection involving the policy provisions, coordinating all of the various aspects of the groups with the field. We had 3,000 groups and approximately a billion dollars in premium in these lines that we have covered.

These areas include responsibility for the group life insurance, the group AD&D, both short term and long term disability coverages, the broad range of medical coverages, all of the way from hospital indemnity coverages to full comprehensive medical benefits.

We also write dental coverage, vision and prescription drugs.

MR. GREGORY: Your Honor, it has been stipulated in this case that Mutual of Omaha were underwriters for accident and health plans for the American Bar Endowment, disability income known as DID, in hospital indemnity, ESP, major medical catastrophe [sic] medical plan, a plan providing accidental death benefits up to \$250,000, known as DD 250.

\* \* \* \* \*

[628] [Holt-Direct] Q. You testified that you have participated in sessions with Endowment personnel where rates were negotiated?

A. Yes.

Q. Have you participated in sessions with other group policy holders in which the subject of rates were negotiated?

A. Yes.

Q. Are you able to state whether your negotiations with the Endowment over rates were typical of your discussions and negotiations with other group policy holders?

A. I think there is a significant difference.

Q. What is that difference?

A. In general in our negotiations on premium rates, we, of course, are looking to have a premium rate which will pay for the claims expenses and provide for a margin for fluctuations in the experience. Most of the policy holders are looking to minimize their cash layout and their cost. In the Endowment they are looking for a certain level of refund.

To go back to the general situation, if we agree upon a rate increase and then that develops a significant refund in the following year, then we are frequently criticized for developing too conservative a premium rate.

In 1979, when we had our first premium adjustment on the Endowment, which was on the major medical program, at that time, which was when I attended my first board meeting to make a [629] presentation for that premium rate adjustment.

In going through the figures and the projected experience, when we finished it was a considerably different reaction than we typically receive from the group in that the Endowment was concerned whether it was going to continue to generate a refund, and, as I recall, there was some discussion that if it is not willing to continue the refund then perhaps we should drop the program.

Q. Have the rates on any Endowment insurance plans underwritten by Mutual of Omaha been decreased over the years?

A. Yes, in the disability income program.

Q. Do you know when rate decreases were made?

A. I don't recall the dates that they were made. I think there was one time when benefits were increased twenty percent without any increase in premium rates, which is in effect a rate decrease, and I believe it was when we wrote the group there was a rate reduction from the prior carrier's rates.

Q. Did you participate in discussions with Endowment representatives concerning the reduction of rates?

A. Yes, I believe so.

Q. Was any reason given to you for the rates being reduced?

A. My recollection of the discussions was that it was felt that the refunds were getting almost too high. I believe on the [630] disability program we had one or two years where the refunds approached 70 percent, and I don't know precisely what the Endowment's goals are for their premium refunds, but I know the impression that we were given at that time was that this was really larger than their desired goal.

Q. Would you define for the Court the phrase, "experience refund?"

A. Experience refund is basically the premium that is left over, that remains after all incurred claims are provided for and all expenses. In other words, it would be the premium less the incurred claims, less the retention, would equal the premium refund.

Q. In the industry, to your knowledge, is the phrase, "experience credit," used synonymously with experience refund?

A. Yes.

Q. Is the phrase, "retrospective refund," used synonymously with the phrase, "experience credit" and "experience refund?"

A. Yes.

Q. In your experience, Mr. Holt, is group disability insurance normally subject to an experience credit arrangement?

A. On long term disability, such as we have on the Endowment, only the very large groups would be experience rated, so it is really fairly uncommon.

Q. Why did Mutual of Omaha agree to experience rating on [631] the Endowment disability plan?

A. There were basically two reasons. One, in view of the size of the program. You can expect more stability on their experience than you could on a smaller group. Secondly, the premium rates are established at a level, which is redundant, and from reviewing the prior experience with CNA, as well as our own experience, we know that it runs very stable and is going to develop a significant excess of premiums.

Q. Since we are going to be referring to the experience refund, would you be able to put a quick definition on the board or formula on the board that I could then ask you to explain?

(The witness went to the blackboard.)

A. O.K. All right, with a symbol?



Q. That is fine.

A.  $P$  minus  $IC$  minus  $R$  equals—I am going to have two  $R$ 's here. Call this  $E$ .  $P$  minus  $IC$  minus  $E$  equals  $R$ .

Q. Could you give us the clue to your code?

A.  $P$  is premium and  $IC$  is incurred claims. The  $E$  represents our experiences or our retention, and the  $R$  equals the refund. So the premium minus incurred claims minus the expenses would equal the refund.

Q. Would you explain the significance of the various factors in that definition starting with premiums? How do premiums impact an experience refund?

[632] A. Obviously the level of the premiums that are charged is a very key factor in whether any refunds are developed. The premiums basically represent the premiums that are paid on behalf of the insured members throughout the policy period. The incurred claims would be made up of the paid claims on any of those claimants plus any change in our claim reserves that are required to cover future liability on those claimants.

Q. What type of experiences are included under the  $E$ ?

A. Expenses that are provided would include the commissions which are paid to the broker. It would include the premium taxes, the cost of the claim administration, our actuarial and underwriting work, and the cost of the Account Executive's time as well as an overhead allocation.

Q. Is there anything included in the  $E$  other than the expenses you just named?

A. Yes, we would also have a profit factor in there.

Q. You used the word "retention." Am I correct that retention as used by you equals  $E$  as included in your formula?

A. Yes.

Q. Do you use the word "margin" at all in describing your retrospective or experience credit formula?

A. We would not include margin in the retrospective formula.

Q. What is margin?

[633] A. Margin would pertain to the excess in the premium rate over expected claims and expenses of retention. It is used more commonly when you are determining the premium rates on a prospective basis.

Q. Rather than determining experience credit?

A. Yes.

Q. What is Mutual of Omaha's profit on the plans underwritten by Mutual for the Endowment?

A. Approximately one percent.

Q. One percent of premiums?

A. Yes.

Q. Going back to margin, can you state for us the typical margin on a group case within your area of responsibility?

A. Margin would vary with the type of group, depending on how large it is. I would say in general when you get into the larger groups, the margin that we would normally include would be in the area of three to five percent of the premium in setting our rates.

Q. Let me turn to the Endowment plans for which you have been responsible. Can you state the historical margins on the disability plans?

A. I think it has been in the area of forty to fifty percent on the average.

Q. What about in hospital indemnity?

A. It has not been quite as much on in hospital indemnity. [634] Probably more in the area of thirty to forty percent.

Q. Can you summarize the experience with regard to margin on the major medical plan?

A. In the early years the margin on the major medical was quite large, and it has fluctuated. In one year I think it was something less than two percent of the premium, and



in some years since then as a result of our premium rate adjustments it probably has averaged more like twenty to twenty-five percent.

MR. GREGORY: I would like to call Your Honor's attention at this time to paragraph 45 of the stipulation, which sets forth the history of the experience credit or the margin on the major medical catastrophe plan, and explains the impact of inflation upon the results of that plan. That is at page 12. I don't think there is any need, obviously, to read it into the record, but those are facts that have been stipulated concerning this particular plan.

BY MR. GREGORY:

Q. You testified, Mr. Holt, that you participated in setting the original, in the process of setting the original rates for the major medical plan, and that a substantial experience credit was anticipated. Would you explain in your own words what has happened to that plan over the years?

A. The type of coverage which is provided under the major medical is subject to inflationary trends in medical [635] care that we have seen over the past years. As a result, whereas ten thousand dollars was considered a very large claim in 1973, it happens much more frequently today than it did at that time. With the inflationary trends that we have in the medical field and improved medical technology, it has been necessary then to increase the premium rates since the claims cost has gone up and reflected those items.

Q. Do you recall when the rates were first increased?

A. I believe it was in 1979.

Q. The stipulation is that there have been increases in 1979, 1980, and 1981. When these increases were instituted, was there any predictable room in the new premiums for an experience credit being paid to the Endowment?

A. Yes, I believe that we in our discussions with the American Bar Endowment, it was indicated that they would like to have a refund of a least twenty percent. I believe that the premium rates that were charged and effective in 1979 assumed a refund in the area of twenty to twenty-five percent.

Q. Mr. Holt, is the application form utilized by the Endowment typical of the application forms that Mutual of Omaha utilized for group insurance?

A. Not in all respects.

MR. GREGORY: I would like to call Your Honor's attention to page 14 of the stipulations, paragraph 55, where it is stipulated that the applications during the years in issue, [636] which is defined as I defined it previously, contain the following statement: "I understand and agree . . . . that any experience credits apportion [sic] to the group policy shall be made payable to the American Bar Endowment as our contributions from the participants."

BY MR. GREGORY:

Q. Mr. Holt, do any of the other association groups' applications with which you are familiar due to your responsibilities have language similar to the Endowment's application?

A. No.

Q. Can you tell us the approximate number of Endowment members insured in each of the plans underwritten by Mutual of Omaha during 1979 to 1981 fiscal years?

A. I believe there are about 19,000 members insured under the disability program, and in the area of ten to eleven thousand employee members insured under the hospital indemnity and major medical, and then about six thousand members insured under the AD&D program.

Q. Is it your testimony that it is about 11,000 in each of the in hospital indemnity and the major medical?

A. Yes.

Q. Is there a broker on the Endowment case?

A. Yes.

Q. What is a broker?

A. A broker is retained by the group policy holder and he [637] provides advice and consultation for them in regard to the benefits, the level of the premium rates, and really is the policy holder's advisor on all of the insurance matters.

Q. Who is the broker on the Endowment case or who was the broker during the years in issue?

A. James Group Services.

Q. What individual representative of James Group Services primarily?

A. Ray Zumbrook.

Q. Have you met with Mr. Zumbrook?

A. Yes.

Q. Can you tell us what role Mr. Zumbrook has taken on occasions when you have met with him in connection with the ABE plans?

A. In the discussions which we have had it has been with both Mr. Zumbrook and Mr. Breiner of the Endowment, and our presentation has been to the two of them. Mr. Breiner looks to Mr. Zumbrook for advice and his counsel on the various matters and Mr. Zumbrook also will ask questions which he feels are appropriate since he is knowledgeable in the area of group insurance.

Q. How is the broker compensated?

A. Mutual of Omaha pays a commission of three fourths of one percent to the broker.

Q. Is this a fee set by Mutual or is it a negotiated [638] commission?

A. It is a negotiated commission primarily between the broker and the Endowment, but Mutual of Omaha also has a part in establishing that fee.

Q. What is your part, sir?

A. We have some general guidelines which we review as far as the level of commissions, and we want to be assured that the level of commissions is not excessive.

Q. In what respect would a commission level be excessive? Let me rephrase the question.

You stated that you reviewed commissions to be certain that the commission was not excessive. What would cause you to conclude that a particular level of commissions for a particular broker was excessive?

A. We have standard commission schedules which we review and use as benchmarks.

Q. Would Mutual of Omaha pay a different level of commissions to James Group Services if instructed to do so by the Endowment?

A. Yes.

Q. Provided it was within your benchmarks?

A. Yes.

Q. Mr. Holt, is the Endowment an insurance broker on the plans underwritten by Mutual of Omaha?

A. No.

[639] Q. Is it an insurance agent?

A. No.

Q. Does the Endowment, Mr. Holt, receive from Mutual of Omaha any payment of any kind for sponsoring the group insurance programs?

A. No.

Q. Does the Endowment receive from Mutual of Omaha any payment of any kind for providing its name and endorsing the group insurance program?

A. No.

Q. Has the Endowment at any time or is it today being paid any fee for bringing the ABE group to Mutual of Omaha?

A. No, it is not.

Q. Has the Endowment ever been paid or is it being paid today for any services as a market maker?

A. No.

Q. Is it being paid for any services as a broker?

A. No.

Q. Has it ever been?



A. No, it has not.

Q. Is it being paid for any services as an agent or has it ever been?

A. No.

Q. Is the Endowment being paid or has it ever been for assuming any underwriting risk?

[640] A. No.

Q. Does the Endowment assume any underwriting risks with respect to its plans?

A. No.

Q. Would you define underwriting risk?

A. Underwriting risk would be a situation where the incurred claims and the expenses, if those two items exceed the premiums, then that excess has to be borne by the risk bearer, which would be the insurance company.

Q. Could the adverse effects associated with an underwriting risk report a loss?

A. Yes.

Q. Have you heard of the phrase, "deficit position," with regard to group insurance?

A. Yes, unfortunately.

Q. What does that mean?

A. What does a deficit mean?

Q. I hate to bring up a sore spot.

A. We have had a lot of those in the last couple of years. A deficit is a situation where the premium we are charging is not adequate to cover the incurred claims and the expenses, and therefore referring to the formula again, if the premium is less than incurred claims less expenses is a negative figure, then there is a deficit that would exist on the group, and that is borne [641] by the insurance company.

Q. Mr. Holt, did Mutual of Omaha during the years at issue or at any time thereafter or any time before make any payment to the American Bar Endowment for any services or for any reason at all other than the experience credit that you have described?

A. No, we have not.

Q. Why do you pay the Endowment the experience credit?

A. Because they are a group policyholders [sic].

Q. Mr. Holt, who prepares the promotional materials for the group insurance plans of the Endowment?

A. The Endowment prepares the material with our review.

Q. What is the purpose and scope of the review of Mutual of Omaha?

A. We review the promotional material as to its accuracy to make sure that it complies with any laws which exist pertaining to the promotional material.

Q. Do Mutual of Omaha personnel ever offer editorial suggestions on the material?

A. I can't answer that.

Q. Would you tell the Court, please, first of all, what underwriting is in the context of accepting risks from your perspective and who performs the underwriting on the Endowment programs underwritten by Mutual of Omaha?

A. The underwriting of the individual applicants is performed by Mutual of Omaha. The applications are sent in to the [642] Endowment, where they would maintain records, but they don't do any underwriting. The applications are forwarded to our office where the underwriting takes place.

Q. Has the Endowment ever participated in screening applications for Mutual of Omaha?

A. Yes. Up until the last couple of years they did an initial screening of the applicants. I think until that time if it was a clean application, with no indication of any health problems, we would go ahead and issue the certificate to the individual. If there were any problems, then it was forwarded to our office for further consideration.

Q. Did the Endowment have any authority to make an underwriting; that is, to decide whether or not a risk might



be accepted if the situation were not covered by your screening rules?

A. No.

Q. Who pays the claims on the insurance plans of the Endowment underwritten by Mutual of Omaha?

A. Mutual of Omaha pays the claims.

Q. Has the Endowment ever paid claims?

A. No.

Q. What is a group policy holder and what functions does a group policy holder perform?

A. A group policy holder is either the employer or the [643] association. The functions which are performed by that policy holder can vary. In general the situations we are involved in that group policy holder would handle the enrollment, be responsible for communicating the benefits and the premium rates that are required to the insureds, and then collecting the premium from the insureds.

Q. Does the group policy holder represent the group in its dealings with the insurance company?

A. Yes.

THE COURT: Let's take a short break. I am going to see if I can get an opinion filed.

(Whereupon, a recess was taken.)

BY MR. GREGORY:

Q. Mr. Holt, who handles the enrollment functions for the Mutual of Omaha programs pertaining to the Endowment?

A. The Endowment.

Q. The Endowment is the group policy holder. Is it unusual in group insurance for the policy holder to handle enrollment?

A. No.

Q. Can you tell us from your experience what functions group policy holders normally perform?

A. They normally handle the enrollment of the insured in the program. They would normally provide for the premium collection [644] and communicating the benefits and the premium rates to the insureds.

Q. When we were looking at the formula for an experience credit, we were talking about expense factors. Are expense factors in group insurance similar to expense factors in individual insurance coverage in the accident and health field?

A. The expense factors would be considerably lower in group insurance than in individual.

Q. Why?

A. Primarily because the insurance company does not have to get involved in the premium administration and the solicitation of employees.

Q. Do you recall the level of the Endowment's gross premiums in the disability program during the years in issue?

A. Approximately three million dollars a year.

Q. Can you tell us what the experience credits were during the years in issue?

A. It varied. I believe it is in the range of something like \$1,200,000 up to approximately \$1,500,000.

Q. Can you tell us what the gross premiums for the in hospital indemnity program were during the years in issue?

A. The premium was about \$1,200,000.

Q. And what about the experience credit for the same plan during the years in issue?

[645] A. It was approximately half a million dollars.

Q. During the years in issue would Mutual of Omaha have been willing to make a reduction in gross premiums paid for the disability and in hospital indemnity programs?

A. Yes, we would.

Q. And how much of a reduction would you have been willing to make for those two programs, namely, disability and in hospital indemnity?

A. We probably would have been willing to decrease the premium rates by approximately thirty percent.

Q. If you had decreased the premium rates by approximately thirty percent, would you have still been willing to have an experience credit arrangement?

A. Yes.

Q. Could you have reduced premium rates on the catastrophe major medical by thirty percent?

A. No.

Q. Why not?

A. The years in question, the experience is not running as favorable as it was in the earlier years, and where we are after premium rate increases rather than decreases, it is possible if the Endowment had not been desirous of a sizeable refund we would have been willing to have had a lower premium rate increase during those years.

[646] Q. On the catastrophe major medical program?

A. Yes.

Q. During the years in issue, Mr. Holt, would Mutual of Omaha have been willing to enter into a contract with the Endowment whereby retrospective rate refunds or experience credits were paid to members by the Endowment?

A. Yes.

Q. And what about a contract in the years in issue under which experience credits would have been credited to premium contributions for the following year thereby lowering premium charges to the members?

A. Yes, we would do that.

Q. Are you familiar with the term "escrow agreement"?

A. Yes.

Q. Did the Endowment have and does it have now escrow agreements with Mutual of Omaha?

A. Yes, it does.

Q. Would you explain, please, what agreements the Endowment has or had, what an escrow agreement is, what is its purpose or function from the viewpoint respectively of the insurance company and group policy holder?

A. We have three of the four coverages that we provide have escrow accounts.\* \* \*

\* \* \* \* \*

[650] [Holt—Direct] A. Yes.

Q. Mr. Holt, as a group actuary, have you ever heard the phrase, "wholesale price," utilized in connection with accident and health insurance?

A. No.

Q. Have you ever heard the phrase, Mr. Holt, "retail price," utilized in connection with accident and health insurance?

A. No.

Q. Drawing upon your experiences, have you ever heard the word, "middleman," utilized to refer to a group policy holder?

A. No.

Q. Based upon your experiences, Mr. Holt, is there anything unique about a large group having favorable mortality and morbidity experience?

A. I would like to say that it is not unique. It is, unfortunately. In the last couple of years we have had more situations where it has not been favorable than we have had favorable. It is certainly our desire on all of our groups that the experience be favorable.

Q. On the DID and the ESP plan, has the Endowment had favorable morbidity experience from your perspective?

A. Yes.

\* \* \* \* \*

[676] [Holt—Cross] A. The second difference that comes to mind is that in the communication or solicitation of the program to the insureds, I think it takes on a different type of communication. In the employer-employee situation usually it can be handled through either meetings of the employees or through the inter-office mail.

Obviously on an association it is difficult to have a face to face communication, and so in that situation I think generally it is handled through the mails.

Q. Would there be a distinction as far as the group policy holder representing the group in the employee situation and the association situation?

A. I don't really see a distinction there. There could be in some situations in some associations. The associations have different objectives. In some situations the associations are using the program just to attract members, and in some instances I don't believe that is the case.

Q. They are using it to make a profit?

A. No, I am not aware of any situations that we have where the association is using insurance programs to make a profit.

\* \* \* \* \*

[695] [Holt—Cross] Q. Why would you be making this type of comparison?

A. There could be a number of reasons why it were made. I think one of the conclusions that one would draw from looking at this program is that the Endowment rates for older employees is lower in relation to our manual, and that the rates for the younger members is much higher, which indicates that the younger employees are subsidizing the older rates. If we were charging our regular actuarial rates that are in accordance with our manual, we would be charging lower rates for the younger people.

What we are really saying is if they want to increase the premium rates for the older employees we can lower the younger ones.

Q. What does 75 percent industry factor mean, .75?

A. Point seventy-five industry factor would reflect that the particular insureds that are covered by the Endowment policy are a better risk than is anticipated in our manual, and therefore they have been discounted 25 percent to reflect that favorable morbidity.

Q. Why would you take that into account in a rate, for instance?

A. You note that footnote applies to the manual rate. The Endowment's rate is the gross rates that are included in the brochure.\* \* \*

\* \* \* \* \*

[724] ELIZABETH LOCKE

was called as a witness by counsel for the Plaintiff and having been duly sworn by the Trial Judge, was examined and testified as follows:

BY MS. CARPENTER:

Q. Miss Locke, would you state your name and address for the record?

A. My name is Elizabeth Locke. I live at 3611 West 214th Place in Madison, Illinois.

Q. And you're employed by the American Bar Endowment?

A. I am.

Q. And how long have you been employed?

A. Since 1977, six years.

MS. CARPENTER: Your Honor, in order to save time, I asked Miss Locke to make some notes as to her various positions at the Endowment and I'm going to ask her simply [725] to describe what she did when for the Endowment?

A. When I was hired by the Endowment in October of '77, I was hired as their production coordinator and that involved monitoring budget expenses and expediting the mailing printing of pieces for the insurance programs. In the spring of 1978, I was promoted to Assistant Manager of Publications Department and my responsibilities stayed pretty much the same.

In January of 1979, I was promoted to the manager of the Department and at that time I began taking on some of the editorial responsibilities for actually writing the direct mail pieces.



Q. Miss Locke, by what means are the Endowment insurance programs promoted?

A. We use exclusively direct mail.

Q. Do you ever advertise in magazines?

A. Yes, we do.

Q. And what magazines do you advertise in?

A. We limit that to ABA publications.

Q. Do you ever advertise on radio or television?

A. No.

Q. During the period of July 1, 1978 to June 30, 1981, which I'll call from now on the years in issue, during the years in issue were the Endowment insurance programs promoted [726] to anyone besides Endowment members?

A. No, we only promote to the ABA, ABE membership.

Q. And do you have custody and control of the Endowment files containing publications sent to Endowment members?

A. Yes, I do.

Q. Now, during the years in issue, how often were the Endowment insurance programs promoted to the members?

A. Normally each of the insurance programs was promoted once each year.

Q. And are there any exceptions to that?

A. Yes, occasionally [sic], for various reasons we would not be able to complete the full promotion schedule of one program once each year.

Q. And would you ever promote a program more than once a year?

A. Yes.

Q. How often would that occur?

A. Very infrequently.

Q. I'm going to show you what's been marked as Exhibit 862 and ask you if you can identify it.

A. Yes, this is a summary of promotions and what it is is a summary of the promotion responses for each of the promotions mailed during the fiscal year of '78-'79.

Q. Now, I'd like to direct your attention to page one [727] which is actually the third page of this document and if you could explain to the court what is represented on page one?

A. Page one is the actual mailing schedule and it lists the promotion being mailed, the people receiving it and the approximate quantity.

Q. Would the numbers in parenthesis be the numbers of members who received that particular item?

A. Yes, the disability promotion, the first one listed, the second mailing quantity is incorrect on here. It should be—If you read, to whom it was directed, it's identical to the first, so it should have been 170,000 rather than 70,000.

Q. So, would I read this correctly that on August 14th, 170,000 members received a brochure with respect to the disability and the ESP program?

A. That's right.

Q. And then on August 28th those same members got another brochure about the same program?

A. That's right.

Q. And then on August 21, what's termed an annual report was sent to 60,000 members. Now, to whom were the annual reports sent?

A. The annual report that year was sent only to members who were insured in any or several of our insurance programs.

[728] Q. I'm going to show you what's been marked as Exhibit 313 and ask you if that is the annual report referenced?

A. Yes, it is.

Q. And, what's the purpose of this annual report?

A. It's a courtesy to our membership, to let them know that by way of the donations that they've made to the insurance programs exactly what's been accomplished by the recipients of the grants for that year. Sometimes it will cover projects that are long term projects and keep them up to date, where they stand with those projects.

Q. And was this sent every year to the insured members?

A. Yes, it was until four years ago, we published the annual report instead in the American Bar Association Journal.

Q. And what is the circulation of the American Bar Association Journal?

A. That goes to everyone of the American Association members as well as some of the law students, law student division of the ABA.

MS. CARPENTER: Your Honor, I move Exhibit 313 be admitted into evidence.

MR. DENNIS: No objection.

THE COURT: It's admitted. You haven't moved —

MS. CARPENTER: I was going to do it later, but [729] I'll do it now.

THE COURT: I was just asking.

MS. CARPENTER: I'll move it into evidence at this time, Your Honor.

MR. DENNIS: I think all the promotion summaries are stipulated that they're admissible. No objection.

THE COURT: Than [*sic*] they're both admitted.

(Plaintiff's Exhibit No. 313 and 862 was received into evidence and made a part of the record thereof.)

BY MS. CARPENTER:

Q. Next, Miss Locke, I'd like to direct your attention to the insurance benefits report, which is indicated there on page one. Could you tell us to whom that was sent?

A. The insurance benefit report is an itemized listing of individual member coverage. It's personalized. One is

sent to each of our insured membership letting them know exactly what coverage they have, as well as the benefits and premiums.

THE COURT: I wasn't catching where — Is this part of Exhibit 862?

MS. CARPENTER: The fourth item down that's listed under the promotion schedule indicates an insurance benefits report mailed to all insured members.

THE COURT: All right.

[730] BY MS. CARPENTER:

Q. Miss Locke, I'm going to show you what's been marked as Exhibit 839 and ask you if that is the report of reference there?

A. That is.

Q. Does this insurance benefits report make any reference to the functions or purposes of the Endowment?

A. Yes, it did. Most of our material that's mailed out does. This appears on the back of the statement.

MS. CARPENTER: I offer 839 in evidence.

THE COURT: Has that been stipulated?

MS. CARPENTER: I don't believe, sir.

MR. DENNIS: No objection, Your Honor.

THE COURT: Okay, it's admitted.

(Plaintiff's Exhibit No. 839 was received into evidence and made a part of the record thereof.)

MS. CARPENTER: And they're such attractive, brightly colored exhibits.

BY MS. CARPENTER:

Q. I notice under the September 18th mailing of the insurance benefits report there's a reference to an October mailing of something called the Combo. Could you tell us what that was?

A. Yes, the combination booklet is a single bound [731] format, descriptions and applications of each of the five group insurance programs.

Q. And, does the combination booklet contain a statement with respect to the purposes of the Endowment?

A. Yes, it does. Usually there's one somewhere on the cover or back cover and in the descriptions of the programs themselves.

Q. Miss Locke, next I'm going to show you an exhibit that's been marked as Exhibit 791 and ask you if you can identify it?

A. Yes, I can. This is a booklet that covers the purpose of the Endowment, the fact that it's a charitable organization and that we make grants to further legal research. It's [sic] use has been in our new member's solicitations. Each week we get lists of new members of the ABA and this was a letter from the President of the Endowment. It is mailed to each of these individuals, new members.

Q. And, what is the purpose of mailing out the booklet?

A. To educate them about what the Endowment is.

Q. Does the booklet make reference to the insurance program?

A. There's a brief summary of what the insurance programs are, what they offer.

Q. And what is the primary focus of the booklet?

[732] A. To let them know that we're a charitable contribution and through their participation in the insurance programs that they can further the activities of the Endowment, funding legal research.

Q. And for how long was this booklet or similar booklets used?

A. Very possibly before 1976. My earliest file copy that would indicate that it was used in the new member campaign was 1976.

Q. And prior to 1976, was there any letter or booklet that went to new members to explain what the Endowment was and what it did?

A. I'm sure there was. The files of the Endowment for years prior to '76-'75 [sic] are not entirely complete and they don't give adequate descriptions of the use of whatever the pamphlets were.

Q. But do you have letters from the president in your files that indicated what the Endowment is and what it does?

A. Yes.

Q. And, is this booklet still in use?

A. No.

Q. Why was it discontinued?

A. It's a matter of economizing. This particular text is expensive and just a matter of budget, we decided to [733] eliminate this and consolidate the two mailings into one. About the same time we eliminated the use of this booklet, we created a pamphlet.

Q. I show you what's been marked as Exhibit 333 and ask you if that is the pamphlet you referenced?

A. Yes. This was developed in about June of 1980 and it's initial use was for distribution at admission ceremonies, state bar admission ceremonies. The American Bar Association membership department attends the ceremonies or at least several of the major ones and they offered to distribute these on our behalf.

And about a year later we added a lot more information to this booklet and began mailing it to graduating law student division members.

Q. Does it continue to be used at Bar admission ceremonies?

A. Yes, it does.

Q. And is it part of your new member campaign?

A. No, it's not.

Q. When did you discontinue use of the "What It Is, What It Does" booklet?

A. About June of '80.

Q. And that was replaced with the salute to new lawyers?

[734] A. No response.

Q. Miss Locke, I think it would refresh your recollection if you looked at the print date on the "What It Is, What It Does?"



A. That's right, 2-81. So, we used it—Probably that was the print date. We used it through the end of that fiscal year, so during the summer of '81 is when it was finally discontinued.

MS. CARPENTER: Your Honor, I offer Exhibit 791 and Exhibit 333 in evidence.

MR. DENNIS: No objection, Your Honor.

THE COURT: Okay, admitted.

Plaintiff's Exhibit No. 791 and 333 were received into evidence and made part of the record thereof.)

BY MS. CARPENTER:

Q. Miss Locke, I'm going to show you what's been marked as Exhibit 883 and ask you if you can identify it?

A. Yes, this is another summary of promotions for essentially the fiscal year '79-'80. There's one or two that overlap into the next fiscal year. It's just a one-line summary as opposed to providing a breakdown of response, as well as sample materials.

[735] BY MS. CARPENTER:

Q. Would the numbers under the heading, Mailing Total, indicate the number of members to whom a brochure was sent?

A. Yes, that's right.

Q. And I notice you use the word prospects on there. What does that mean?

A. That's to distinguished [*sic*] from those people already insured in the program, their uninsured [*sic*] people.

MS. CARPENTER: Your Honor, at this time I offer 883 in evidence.

MR. DENNIS: No objection, your honor.

THE COURT: Admitted.

(Plaintiff's Exhibit No. 883 was received into evidence and made a part of the record thereof.)

BY MS. CARPENTER:

Q. Miss Locke, what was the budget for the publications department during the years in issue, approximately?

A. It averaged between \$300,000 to about \$360,000 each year.

Q. And, what expenses did that budget cover?

A. It was assembled to expedite the mailings and all of the costs incurred in producing these mailings, which would include promotional materials, the expense of mailing [736] house postage, express and freight, data processing for the labels, that's about it.

Q. Next I'm going to show you what's been marked as Exhibit 813 and ask you if you can identify it.

A. This is another—Or, this is a combination booklet, typically used in a new member mailing list. After the new member would receive the, "What It Is, What It Does" book that explains the purpose of the Endowment, he would receive this combination booklet with a letter from the Administrator, explaining each of the insurance programs.

Q. Would anyone besides new members receive a combination booklet?

A. Yes, in response to calls on our watts line or direct calls to the office or even correspondence if someone was requesting insurance information, these would be mailed to them.

Q. And approximately when was this particular booklet used?

A. This is a print date of '76, so it was probably used for most of 1976.

Q. And, is there reference in the combination booklet to the purposes of the Endowment insurance program?

A. Yes.

Q. And, could you direct us to where that appears?

[737] A. As you open the inside front cover,—

Q. That block entitled, "The Endowment Story?"

A. Yes.

Q. Next I'm going to show you what's been marked as Exhibit 799 and ask you if you can identify it.

A. This is yet another example of the combination booklet that we, again to new members as a second mailing with a letter from the Administrator. This was used at—As this previous combination booklet was depleted, this was created to take its place at the end of '76.

Q. And, how long was this booklet used for?

A. Probably just for that fiscal year.

Q. And, does it also contain a statement with respect to the purposes of the Endowment Insurance Program?

A. Yes, the member would receive this with the label on the front, where the gold tab is you open it up and it would be right there on your right, the Endowment purpose.

Q. So, the mailing label would be on the front where the gold seal is and when the member opened it up, that would be apparent there?

A. Yes.

MS. CARPENTER: Your Honor, I offer Exhibits 813 and 799.

MR. DENNIS: No objection.

[738] THE COURT: Okay, admitted.

(Plaintiff's Exhibit No. 813 and 799 was received into evidence and made a part of the record thereof.)

MS. CARPENTER:

Q. Miss Locke, next I'm going to show you Exhibit 332 and ask if you can identify it.

A. Yes, this is another combination booklet that was used as a second mailing in the new member campaign. It was used for the period August '79 through April 1980.

Q. And, is there a statement with respect to the purposes of the Endowment in this combination booklet?

A. Yes, this booklet is unique in that it had a die cut in the back that would hold the applications and there is two statements in this particular book, one on each side as you open it to get the applications. One is the Endowment story and one specifically addresses the premium refunds agreement.

Q. So that, in order to pull out an application you would have to see the statements with respect to the purposes of the program?

A. Yes, several statements, as well as in the application.

Q. Now, has the application always referenced the disposition of dividends or experience credits? (Witness nods head.) You have to [739] say yes.

A. Yes, always.

MS. CARPENTER: Your Honor, I offer 332 in evidence.

MR. DENNIS: No objection.

THE COURT: Okay, it's admitted.

(Plaintiff's Exhibit No. 332 was received into evidence and made a part of the record thereof.)

BY MS. CARPENTER:

Q. Miss Locke, next I'm going to show you Exhibit 331 and ask you if you can identify it?

MS. CARPENTER: And, your Honor, we didn't have two copies of the original 331, so in order that you could see the format of 331, I brought a subsequent version, that the pockets are the same, but the inserts are different, so I'll take this back, but I just wanted you to see what the original looks like, if there's no objection from Mr. Dennis?

MR. DENNIS: No objection.

THE COURT: Thank you.

WITNESS: Yes, this was the combination booklet that was developed when we stopped using the previous exhibit which was in June of 1980 or April of 1980. It was used until June of 1981. This was again a followup mailing to new members after they had received a greeting from the [740] new president and the booklet about the Endowment functions.

This particular brochure was developed purposely with pockets to hold individual brochures to accommodate changes in the brochures that could then just be one brochure taken out and thrown away. It was an effort at economizing.

Q. Okay, but the reference to the Endowment story would stay the same, no matter how the plans changed?

A. Yes, the jacket itself never changed but the contents did.

Q. Is that jacket still in use?

A. Yes, it is.

Q. And, would all of these combination booklets have been sent to members who inquired about the program in addition to new members?

A. Yes, always.

MS. CARPENTER: Your Honor, I offer 331 in evidence.

MR. DENNIS: No objection.

THE COURT: Admitted.

(Plaintiff's Exhibit 331 was received into evidence and made a part of the record thereof.)

BY MS. CARPENTER:

Q. Miss Locke, next I'm going to show you Exhibits 203, 202, 201 and 219 and ask you if you can identify them?

[741] A. These represent tax deduction notices that are sent to our insured membership annually. In the earlier years, a card was produced for each of the programs, advising the member of the percentage of their premium payment that they could deduct on their income tax as a charitable contribution.

In later years, as an effort for economizing, as well as we had more to say about the contribution issue, we went to a folder that could list each of the insurance programs and their respective dividend amounts so that all of the members insured would receive all of the information

with an added paragraph about the adverse ruling about charitable contributions, letting the members know that we would advise them as developments warranted.

Q. Now, were these notices sent to every insured [sic] member?

A. Yes, there were, each year, as the figures became available from our auditors, usually in November or December and they were mailed first class to the membership.

MS. CARPENTER: Your Honor, I offer these exhibits in evidence, that's 201, 202, 203, and 219.

MR. DENNIS: No objection.

THE COURT: Okay, they're admitted.

MS. CARPENTER: Thank you, Your Honor.

[742] (Plaintiff's Exhibit Nos. 201, 202, 203, and 219 were received into evidence and made a part of the record thereof.)

MS. CARPENTER: Your Honor, in order to save time, I have clipped together exhibits 204 through 214, 216 through 218, 220 through 224, 189 through 200 and Exhibit 801.

These are the deduction notices for earlier years. They've all been stipulated into evidence, except for some reason Exhibit 801 was admitted from that and I have clipped your copy together in chronological order rather than in exhibit number order because it makes more sense that way, but the originals are simply clipped and not stapled together.

I'm going to ask the witness to identify these cards.

THE COURT: What were those numbers again?

MR. DENNIS: They've already been stipulated in the stipulation. I don't see any reason to have her identify them. We don't have any objection to their admission into evidence.

MS. CARPENTER: Yes, there's only one that's not stipulated and that's 801 and I assume you don't object to that.



MR. DENNIS: I have no objection to that.

[743] THE COURT: There's no reason to have the witness identify them then, if you want to ask questions about them, but I would like to know what those numbers were again for my records.

MS. CARPENTER: 204 through 214, 216 through 218, 220 through 224, 189 through 200 and then 801.

THE COURT: All of those are admitted by stipulation.

MS. CARPENTER: Thank you, your Honor.

Plaintiff's Exhibit Nos. 204 through 214, 216 through 218, 220 through 224, 189 through 200 and 801 were received into evidence and made a part of the record thereof.)

BY MS. CARPENTER:

Q. My only question for the witness was, how far back in the Endowment files do you find these tax deduction notices?

A. As far as we can discover in our own files, 1964.

MS. CARPENTER: Thank you. Your witness, Mr. Dennis.

MR. DENNIS: Your Honor, before we start, could I have five minutes to get my exhibits together. We were trying to call out last night what we were going to use this morning and we haven't quite completed the process.

THE COURT: Trying to find a few juicy ones?

\* \* \* \* \*

[748] [Locke—Cross] A. If you see me sitting like this, I'm having trouble hearing.

MS. CARPENTER: The witness has a hearing problem.

THE COURT: We'll all speak up.

BY MR. DENNIS:

Q. I'd like to show you what's been marked as Defendant's Exhibit 538. I'd like to ask you if this is a document that you would use in developing your—the budget that you have for your publications department?

A. Well, this is something that's developed in concert with the development of the budget. Initially we work kind of backwards. There's given an appropriate budget figure, arrange, and meeting with Mr. Breiner and he tells me what he would like to accomplish in the way of promotions that year, what age groups, et cetera.

My heaviest responsibility here is to specify actual package formats and costs, broken down and attach bid sheets to accomplish the objectives that Mr. Breiner has indicated.

Then probably the last thing we do is develop this particular mailing schedule.

Q. And this is then sent to the insurance carrier?

A. The mailing schedule?

Q. Yes.

[749] A. No, it's not. Sometimes as a courtesy we'll do that. It's nothing they have to approve or disapprove.

Q. Now, would this be a typical mailing schedule that you would have during the years 1979 through 1981?

A. Yes, it represents a single mailing to each of the insurance programs.

MS. CARPENTER: Mr. Dennis, was your question whether she had a schedule like that? You mean the piece of paper, or do you mean the frequency of promotion?

MR. DENNIS: The frequency of promotion, the schedule.

BY MR. DENNIS:

Q. Is this a typical promotion schedule?

A. It appears to be, one mailing or one major promotion for each of the insurance programs.

Q. Now, how many promotional packages might an individual receive who is a member of the Endowment during the year? Could it be as many as 12?

A. Well, there's five group insurance programs. Each one's promoted and there are two mailings. For each mailing, a separate age group is determined. If the age groups

overlap and that person is in that overlapping area, he would receive a maximum of ten mailings, two of each of the insurance programs.

[750] MR. DENNIS: Your Honor, I move that what's been marked as Exhibit 538 be admitted into evidence.

MS. CARPENTER: Your Honor, I don't object, but I note for the record that it's a schedule for one of the years that's not in issue and we've already put into evidence what schedules we have for the years at issue.

WITNESS: I should also point out to you that that's our goal or objective for the year and many times it's not met. We either don't complete it, or we reschedule the promotions and that particular one, there's indications of a number of page ads, or quarter page ads that we never accomplished.

BY MR. DENNIS:

Q. But this would be sent to the Board when they're approving the budget?

A. Yes.

THE COURT: Mr. Dennis, I'll admit it, if there's no objection, but just so I know what to do with it.

MR. DENNIS: I'm just offering it into evidence to indicate the review process that goes on concerning the budget and the fact that the Board of Directors reviews the advertising budget. \* \* \*

\* \* \* \* \*

[777] [Locke—Cross] Q. And the insurance carriers would approve that statement?

A. Yes.

Q. I'd like to call your attention to what's been marked as 900-A. Is this an exhibit which you prepared?

Excuse me, is this a piece of promotional literature that you prepared?

A. Yes, it is.

Q. You came up with the idea to use the bandaid on the cover?

A. Yes, I did.

Q. What did you intend to indicate when you were using the bandaid?

A. It's an understatement.

Q. It's a what?

A. An understatement.

Q. Indicating to the member what? What were you attempting to convey to the person that was reading the literature?

A. That this is something that is far—that it's catastrophic insurance and mentioning that when a simple bandage isn't enough, is almost being sarcastic. It's an understatement.

Q. Now, in the fourth paragraph when you state, in [778] the second sentence, read the facts explaining how the plan works and how little it costs in terms of the benefit potential. When you're stating how little it costs, you're again referring to the semi-annual premium payment?

A. Premium payment, yes.

Q. Now, the second page of the promotional piece, you have a listing of various diseases that scare me just looking at them. Would you read the first four diseases?

A. Would I read them?

Q. Yes.

A. Yes. Carcinoma, stomach. Cystic Fibrosis, Coronary Artery Disease, Multiple Sclerosis.

Q. What would be the medical expense submitted on the right-hand side? What would that be to indicate?

A. Do you mean why did I have it there or what is it?

Q. Yes, what is it and why did you have it there?

A. Both. It's included to show the amount of money that was paid to the members after they established their chosen deductible amount, which was \$15,000.

Q. And you've got how many examples on the page there, 30-40?

A. Several.

Q. Would you call this a hard sell advertising?

A. No, I wouldn't.

[779] Q. Isn't this an example of scare tactics?

A. Actually no, it's not.

Q. Do you recall the deposition?

A. Yes, I do, Mr. Dennis, very well. And, your question to me during the deposition was exactly that, would you call this a hard sell approach and I said, no, I would call it a scare tactic and that was after about 18 hours of being deposed and identifying about 35,000 different documents and it was an effort to dismiss further discussion because we had been through this several times during the deposition. You were trying to insist that we use hard sell, me asking you to define what hard sell was, and so if you're asking now if this is hard sell, I say, no, that it's not.

Q. Did counsel advise you how to respond to the question?

A. No.

Q. What kind of sell would you call it? Soft sell?

A. Quite frankly, Mr. Dennis, I don't—at the entire time I've worked at the Endowment have never felt compelled to categorize styles I use in my cover letters. I can tell you why I did this, why I listed it this way. I thought it was a very effective way to let anybody know who is not actually experienced hospital expenses that the cited \$10,000 [780] or \$15,000 deductible amount, which seems just staggering is not, in comparison with the actual claims or payments of claims made after the deductible has been established. This is a sampling of more than 150 claims that were at work at the time.

Q. I'd like to call your attention to what's been marked as Exhibit 909, excuse me.

A. Exhibit number what?

Q. 909.

A. I have 909-A.

Q. Yes, excuse me, that's the exhibit number, 909-A. Now, did the Endowment also advertise their insurance product in magazines?

A. Yes, the Endowment uses three ABA publications, to periodically place page ads. One is the ABA Journal, the other is the Young Lawyer Divisions, Barrister Magazine and the third is the Law Student Division, Student Lawyer Magazine.

Q. Now, on the—what's been Bate marked as 8017,—which would be the sixth page of the document, states, when you see the semi-annual group rates, I believe you'll agree this is also of insurance protection at a very economical cost.

Is this a piece of advertisement that was used on this page by the Endowment?

[781] A. It is a copy of a page ad that appeared in the American Bar Association Journal, yes.

Q. Would that be typical of the type of reference that you would have to cost in the American Bar Association Journal?

A. I didn't find where you were quoting, Mr. Dennis. What's typical about it is that we refer to the premium always as affordable group rates or economic costs, yes, that's typical.

Q. That would be the semi-annual premium that the member would have to pay to the Endowment?

A. The cost we're referring to is premium payment, yes.

Q. Now, which magazines again did you say that you published in, the ABA Journal and what other magazines?

A. The ABA Journal, which is the one we placed page ads in most frequently and we also have the option of using the ABA's Barrister, which is a young lawyer publication and student lawyer, which is law students.

Q. And the page I've shown you would be a typical advertising piece that you would use in those magazines?



A. Well, no, in the Journal and the Barrister Magazine, they're received by full privileged voting members of the ABA, so we could mention cost and the insurance program.

\* \* \* \*

[801] [Locke—Cross] Q. I'd like to read to you the last two paragraphs of what's been marked as Exhibit 781. Competition for our specific marketing includes every legal group having group insurance plans, including alumni associations, fraternal organizations and other legal associations, such as American Association of Trial Lawyers, the Federal Bar Association, Criminal Law League, the Legal Arts Insurance Trust, to name just a few, and also the law student division of ABA, offers insurance to students while still in law school and provides a special conversion after graduation.

In the next paragraph, direct mail competition for the insurance market, in general, includes the major credit card companies like Visa, Master Card and American Express, as well as the major oil companies and department stores.

Where did you get this particular information? Did Mr. Breiner provide some of that information to you?

A. Where did I get this? Well, in the first paragraph that you referred to, I get samples of their material and we keep them on file. Now, when I say competition in this context, I'm talking about the fact that they're available. I'm not talking about benefits or features or rates, just [802] the fact that these people also can reach the members of our group and offer them insurance.

This second paragraph, just as my own experience.

Q. And, I'd like to now call your attention to what's been marked as Exhibit 1303, 1304, and 1305 and ask you if those are the responses that you received from the three companies, with respect to the letters that you mailed to them?

A. 1303, 1304, and 1305?

Q. Yes?

A. Yes. Well, let's see. They enjoyed meeting with us. These are not responses to the correspondence from Rick Breiner. These are—This first one anyway, 1303, is, after having met with Rick Breiner and myself, to discuss all of that.

I suspect that's true of the Burson Marsteller, yes, and also Richard's Direct. This is after initial meetings with us.

Q. Now, was the Kestnbaum company ultimately selected?

A. Pardon?

Q. Was the Kestnbaum Company ultimately selected?

A. Yes.

MR. DENNIS: Your Honor, I move that these documents be introduced into evidence.

\* \* \* \*

[809] [Locke—Cross] A. When I wouldn't want it to be clear?

Q. Yes.

A. It's not a case of not wanting it to be clear. It would be addressing an area that is ambiguous to begin with. Like group rates, where we stand with group rates. They go all over the Board. So, we don't want to say to the membership, we have the worst group rates there are, because we're trying to get them to enroll in the programs.

So, we say, reasonable group rates, attractive group rates, modest group rates and that's in that—That's why it's purposely ambiguous.

Q. Do you hope that the member will be influenced by the language choice that you use in deciding whether or not to buy the product?

A. If they—I hope they're influenced by what?

Q. The language that you use in the material?

A. Well, I don't expect to really capture them with exactly what I'm writing. We're obligated to give them some information about the programs and of course we want that to be as positive and perceived by them as positively as possible so that they would consider enrolling in the programs.

I rely as well on the features of the insurance programs, the unique position of the Endowment, to draw them in, so there's really three factors that I'm relying on to kind of counter my copywriting.

(5)  
No. 85-599

RECEIVED

FEB 14 1986

OFFICE OF THE CLERK  
SUPREME COURT, U.S.

**In the Supreme Court of the United States**

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT

UNITED STATES OF AMERICA, PETITIONER

v.

FREDERIC D. TURNER, ET UX., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT  
OF APPEALS FOR THE FEDERAL CIRCUIT

**JOINT APPENDIX**

FRANCES M. GREGORY, JR.  
*Sutherland, Ashill & Brennan*  
*1666 K Street, N.W.*  
*Suite 800*  
*Washington, D.C. 20006*  
*(202) 872-7800*  
*Counsel for Respondents*

CHARLES FRIED  
*Solicitor General*  
*Department of Justice*  
*Washington, D.C. 20530*  
*(202) 633-2217*  
*Counsel for Petitioner*

**PETITION FOR WRIT OF CERTIORARI**  
**FILED OCTOBER 7, 1985**  
**CERTIORARI GRANTED DECEMBER 2, 1985**

**Volume II**

302/72



## TABLE OF CONTENTS\*

	Page
1. Claims Court docket entries .....	1
2. Court of appeals docket entries .....	17
3. Complaint, Cl. Ct. No. 465-82T .....	21
4. Answer .....	33
5. First amended answer .....	37
6. First amended complaint .....	41
7. Answer to first amended complaint .....	45
8. Complaint, Cl. Ct. No. 163-83T .....	47
9. Answer .....	53
10. Excerpts from transcript of proceedings, May 12, 1983, before the Claims Court .....	56
11. Joint memoranda re stipulations .....	71
12. Excerpts from transcripts of proceeding, October 11 through November 11, 1983, before the Claims Court ..	112
13. IRS General Counsel Memorandum (G.C.M.) 36713 ..	541
14. Order allowing certiorari .....	543

---

\* The opinion and judgment of the court of appeals, and the opinion and judgment of the Claims Court, are printed in the appendix to the petition for writ of certiorari and have not been reproduced here.

\* \* \* \* \*

[813] THE COURT: Be seated. Sir?

MR. GREGORY: May we call another witness?

THE COURT: It's okay with me. That's what we're here for.

MR. GREGORY: Mr. Breiner, Your Honor.

THE COURT: Raise your right hand, please.  
Whereupon,

RICHARD S. BREINER

was called as a witness by counsel for Plaintiff and, having been duly sworn by the Trial Judge, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. GREGORY:

Q. Preliminarily, Your Honor, I told Mr. Breiner that when I use the phrase, the years in issue, we were referring to the period July 1, 1978 through June 30, 1981. I would note that Mr. Breiner has been with the Endowment for some 26 years. I will try and be as precise as I can, if I am referring to time frames outside of the years in issue and I'm certain counsel for the United States will do the same.

I've asked Mr. Breiner, as has been our practice, to prepare a summary of his background, work experience and I'd ask him to give that to you at this time, together with [814] his full name and home address.

A. My name is Richard S. Breiner. I reside at 32 Arapahoe Drive, Thornton, Illinois. My work experience prior to 26 and a half years with the American Bar Endowment included, Akron Automobile Dealer's Association, Siberly Rubber Company, National Tire Dealer's and Retreader's Association, NURSICA, which was a home improvement association in New York.

I worked for the General Motor's Corporation in Cleveland, Ohio, as an expeditor in their diesel engine division. I worked for the United States Government as an

economist in the Rubber Division of OPA. I also worked for the government for three and a half years as a United States Marine. I think that about covers it.

Q. What was your educational background after high school, Mr. Breiner?

A. I went to Hammill College. That was a business university.

Q. Where was that located?

A. Akron, Ohio.

Q. When did you come to the American Bar Endowment?

[815] A. May 6, 1957.

Q. How did you come to know of a job opening at the endowment?

A. New York Life Insurance Company approached me and asked me if I might be interested in the opportunities with the Endowment.

Q. Who hired you to come to the Endowment?

A. The Treasurer of the American Bar Endowment, a gentleman by the name of Geider, Duke Gieder.

Q. When you arrived at the Endowment, were there any insurance plans in effect?

A. There was a life insurance program.

Q. It had been in effect for two years?

A. It started June 1, 1955.

Q. How many employees were at the Endowment in 1957?

A. There were no full time employees. There was a person that was borrowed from the American Bar Foundation who was an employee of the Foundation and there were two or three ladies from employment agencies that were working there.

Q. No permanent staff?

A. No permanent staff.

Q. When you came to the Endowment, were you informed of the charitable purposes of the insurance program?

[816] A. Yes, they advised me that the main purpose of the insurance programs was so that the participants might make the Endowment beneficiaries of their life insurance policy.

Q. This was 1957?

A. Yes.

Q. Do you know whether the intent of the program of having the Endowment or was it the Endowment or the Foundation designated as beneficiary of the insurance program?

A. I didn't understand the question.

Q. You stated that one of the purposes of the program was to have the Endowment designated as beneficiary. I'm simply asking you if you didn't mean to say the Foundation?

A. Foundation, yes, that's correct.

Q. Do you know whether that, in fact, came to pass in any large dollar amounts?

A. Not in any large dollar amounts, but still today there are certain benefits that the Foundation does derive. It took a long time for anything of that nature to develop.

Q. Do you know the level of the dividends on the life plan in 1957 when you came?

A. I don't believe there were any dividends.

Q. Do you know when the first dividend was?

A. I think it was 1958. The program started in June of '55, so a four years' premium really wasn't developed until June of 1956 and then it was very small. I don't think [817] anything developed til '58. If I recall, I received the first dividend on the program.

Q. Keep your voice up at the end of the sentence.

A. I believe I received the first dividend.

MR. GREGORY: Those amounts are stipulated, Your Honor.

BY MR. GREGORY:



Q. Mr. Breiner, at my request, have you attempted to determine what has been the total income to the Endowment, total receipts by the Endowment from dividends and experience credits over the last 25 years?

A. During the last 25 years, the Endowment has received in dividends and experience credits some \$81,900,000.

Q. And, I also asked you to attempt to determine what the Endowment's expenses have been over the last 25 years. Did you make that calculation?

A. Yes, the expenses during that period time were around \$18 million plus some dollars.

Q. And, did you determine how much the Endowment had made in grants in charitable activities in the field of law?

A. Yes, from those contributions, from the members we have made grants for the advancement of jurisprudence and administration of justice, nearly \$63 million.

Q. Could you describe for me, in general terms, your function as an employee of the Endowment over the last 26-27 [818] years?

A. I work for a Board of Directors and my functions have always been to operate the Endowment as efficiently and effectively as possible through the direction of the Board of Directors.

Q. Does the Board operate through committees?

A. Yes, the Board has several committees.

Q. Would you enumerate the principle committees of the Board?

A. There is an insurance committee, an administration committee, policy committee and investment committee.

Q. Are you a member of any of those committees?

A. No, I am not.

Q. Is anyone a member other than a member of the Board of Directors?

A. No, sir.

Q. Do you have any vote on those committees?

A. No, sir. I have no vote on the Board either.

Q. Thank you. Let me direct your attention to the subject of insurance in the insurance committee. In matters pertaining to the Endowment's insurance programs, have you made comments, recommendations, et cetera, to the insurance committee or to the Board directly?

A. Any comments I might make would go through the [819] committee, it would go to the committee. I would not necessarily make any recommendations whatsoever to the Board of Directors.

Q. Who is the current president of the Endowment?

A. Kenneth Byrnes, Jr.

Q. Did he hold an office prior to being president?

A. Yes, he was vice-president. I think he held the vice presidency for two years before becoming president.

Q. I direct your attention now to the years in issue as we've defined it and could you please summarize the size of your office and the general functions of your staff?

A. During the years of issue we had upwards of 40-42 employees. Office-wise, we had approximately 10,000 square feet of office space. The staff, during those particular years we were moving into word processing and a terminal operation with data processing and we were in a training period along with doing the other functions of the office.

We had other things, other than insurance also. We have a grants program and we have investments and of course, there are numerous meetings. I don't know exactly how to explain the functions of 30-40 people.

Q. Let me ask you this. Could you tell us, in general, what functions your staff performed in support of the insurance programs of the Endowment?

[820] A. Well, we do the billings. We do the solicitations. We maintain the files of the participants of the insurance program. We verify claims that are presented. By that I mean, we ascertain that they are a member in good standing of the Association and that their premiums for that particular program are paid and we verify the benefits for that program.

We process applications to the extent of utilizing what the insurance companies refer to as a field manual.

Q. Is that the same thing as a screening guide?

A. Screening guide, right.

Q. Are there any other functions that you perform in aid of the insurance program?

A. Answer correspondence, inquiries regarding the programs.

Q. Is your office responsible for the preparation of brochures sent to members soliciting enrollment in the program of the endowment, insurance program?

A. Yes, sir, we prepare the solicitations.

Q. Let me direct your attention specifically to the solicitation material. Thinking of any piece of material, would you tell me who has to approve the document before it is forwarded to perspective insurers of the Endowment?

A. Well, the material is drafted and I approve the initial draft.

\* \* \* \* \*

[835] BY MR. GREGORY:

Q. Mr. Breiner, are you a licensed broker?

A. Yes, sir.

Q. In what state?

A. Licensed in the state of Illinois.

Q. Do you perform any brokerage services in the state of Illinois or for any organization?

A. I am a broker and administrator on a life insurance program for the Chicago Bar Association.

Q. Is that done with or without the permission of the Board or the Endowment?

A. The Board is well aware of that activity.

Q. How large is that program?

A. It's a small program. It had about \$86,000. of annual premiums.

Q. Do you serve as broker for any other program?

A. No.

Q. Over the years, have you been asked to advise any organization setting up group insurance programs?

A. I've been requested by certain organizations to either look at their programs, give them my comments, or help them set up the group insurance program of one type or another.

\* \* \* \* \*

[848] [Breiner—Direct] A. I do not know which individuals do the work, but it was done by the data processing center of the American Bar Association.

Q. And the letterhead on both exhibits is American Bar Association?

A. Right.

MR. GREGORY: Your Honor, we offer Exhibits 386 and 387 into evidence.

MR. MARKHAM: No objection, your Honor.

THE COURT: Admitted.

(Plaintiff's Exhibit 386 and 387 was received into evidence and made a part of the record thereof.)

MR. GREGORY: I might say, your Honor, that relevancy of this document become more apparent during the testimony of Ms. Ryerson.

BY MR. GREGORY:

Q. Mr. Breiner, were you familiar with a proposal by James Group Service in 1981 to take over Administrative functions for the insurance programs of the Endowment?

A. Yes, I reviewed that proposal.

Q. According to your understanding, how much of the insurance administration performed by the Endowment would James Group have taken over?

[849] A. They would have taken over all matters pertaining to the Administration Program.

Q. Would there have been any residual functions with regard to the insurance program retained by the Endowment staff?

A. There would be certain functions during the transition period that we would have to have staff to perform. Thereafter there would have to be some staff to do certain clerical work on behalf of the endowment, separate and apart from insurance programs.

Q. And what work would be separate and apart from the insurance program?

A. Well, we have a grants activities where money is allocated for grants. We have investment portfolios, we have a memorial fund. We would have a few people on staff, including myself, I would hope. So, there would always be Board meetings and committee meetings, and the insurance committee of the Endowment would still perform, more or less in the same fashion as they do today. They would approve promotional material and they would recommend to the Board of Directors any changes that might be necessary to take place.

\* \* \* \* \*

[885] [Breiner—Cross] Q. Suppose that when such a dispute developed the member wrote to you or a member of your staff, informing you of the dispute and asking your help, did you ever receive such correspondence from members?

A. We received letters, which I'll categorize in the complaint family, that they have submitted a claim

sometime before, one thing or another, and they have not heard from the insurance company or they were not satisfied with the claim.

Q. In those instances, would you take the matter up with the insurance company?

A. Well, only to the extent of telling the insurance company that the member wasn't satisfied with the settlement. There is nothing we can do. We have never negotiated on behalf of any member and we so state that in the applications that we would not negotiate regarding underwriting or on any claims and we do not.

MR. GREGORY: What's the second one?

MR. MARKHAM: 2310.

BY MR. MARKHAM:

Q. Mr. Breiner, I've just handed you Exhibit 711-B and 2310. Can you identify these documents and state whether they're related?

A. Yes, I would—Exhibit 2310 is undoubtedly a [886] summary of the contents of Exhibit 711-B.

Q. What is the nature of the information contained in these exhibits?

A. It's a very brief summary of state and local Bar association insurance programs.

Q. When was this prepared?

A. I would assume sometime prior to June of 1978.

Q. What was the purpose of preparing this compilation?

A. I've been trying to think of that while you were asking the other questions.

Q. Let me withdraw that and ask you who prepared it?

A. You're asking me who prepared it?

Q. Yes.

A. I don't recall the individual on my staff that actually—

Q. Okay, it was prepared by a member of your staff?

A. It was prepared by someone in my office, yes, sir.



Q. Do you have an opinion whether the data contained in 711-B and summarized in 2310 is accurate, as of the time prepared?

A. Well, without counting all of this and going through them all, I think I would say that the accounts regarding the number of states involved and the number of associations and alumni associations and so on, are contained here in [887] Exhibit 711-B, yes.

Q. Do you know whether this report is furnished to the insurance committee of the Board or to the full Board?

A. I apologize. I couldn't say who this—where this went to. It very well could have gone to the insurance committee.

Q. Have you been able to recall why it was prepared?

A. No, I—I remember this very well, the documents. But as to where it went and the actual reason of why it was prepared, does not come to me.

I would say that it probably went to the insurance committee because of the type of a report it is, it has a cover letter of explanation that would be a courtesy thing to send to the committee. If this went, for instance, to Mr. Zumbrook, why he would already know about this information and we wouldn't have bothered writing a cover memorandum with it, assuming it went to the insurance company.

MR. MARKHAM: Your Honor, we would offer Exhibits 711-B and 2310 into evidence.

MR. GREGORY: No objection.

THE COURT: They are admitted.

(Defendant's Exhibit Nos. 711-B and 2310 were received into evidence and made a part of the record thereof.)

\* \* \* \* \*

[898] [Breiner—Cross] BY MR. MARKHAM: Q. I've just handed you Exhibit 582 and ask if you can recognize this as a copy of a letter you sent to Mr. Lyles?

A. Yes.

Q. I call your attention to the first page in the last paragraph, the first three sentences beginning, "We discussed the possibilities of increasing premiums"—

A. Yes, I recall.

Q. Did you conclude at that time that you could not increase premiums above the competitive range for this program being discussed?

A. Well, I think we agreed that it would not be of any value to increase the premiums. I think without reading this entire document, I think that it is mentioned in here that the rate generally accepted for this coverage is 72 cents a thousand to 85 cents a thousand. And if we went over the 85 cents a thousand, we very well couldn't sell it to anybody. And that a small or reasonable increase, say a 20 percent increase would only be 14 cents so if you were given a thousand or 2,000 members at 14 cents, this would not amount to very much premium buying.

So we decided after all of this that really an increase in premium wouldn't be of any big value.

MR. MARKHAM: We offer Exhibit 582 into evidence, [899] MR. GREGORY: No objection, Your Honor.

THE COURT: Okay. It's admitted.

MR. GREGORY: This was stipulated, Your Honor. We stipulated admissibility.

(The document referred to, previously marked for identification as Defendant's Exhibit No. 582, was received in evidence.)

BY MR. MARKHAM:

Q. Mr. Breiner, I just handed you Exhibit 1706. And ask if this is a document that you prepared?

A. Yes, this is the document that I prepared.

Q. Does this—did the discussion at this meeting deal with the problems of the ADD 250 program?

MR. GREGORY: Your Honor, the first paragraph of the document indicates that it's the major medical insurance program.

BY MR. MARKHAM:

Q. Well, referring then to the second half of the first page—well, excuse me—did this deal with the major medical program?

A. This was the—the essence of this document is dealing with the major medical.

Q. What were the problems with that program as of [900] 1980?

A. It wasn't producing sufficient premiums to pay claims or to give the endowment a satisfactory contribution from the membership.

Q. Was that program retained despite these problems? In other words, kept in effect?

A. We still have the program. We have had three premium increases over the last three years, and we are anticipating a fourth increase next spring so we are maintaining the program with premium increases so that we can get sufficient contributions from the members as well as pay for the administration of it.

Q. Now, going down to the bottom of page one, it says—I would guess that there are very few members that acknowledge of the purpose of the programs for NABEs source of contributions other than a source to obtain group insurance at attractive rates although we continually advertise the endowment's purpose in sponsoring the plans, my reaction is that basically the member is interested in his welfare and not necessarily the endowments. On what basis did you reach that opinion of the members' sentiments toward the endowment insurance programs?

A. Well, number one, there hadn't been a dividend of any size for some time, so the member had nothing to deduct on his income tax as a contribution to the endowment, and [901] it was my feeling that as such he was strictly interested in the product that was being offered, and the price of the product. There is no contributions in-

volved, and so anything that might look attractive to him in, let us say, giving back something to his profession in the form of a contribution to this program was nil so—

Q. Did this statement only refer to the major medical program?

A. This is what we are talking about here, major medical program.

Q. I'm referring you now to the second last sentence beginning that I would guess that—does it say "programs" plural there—"I would guess that there are very few members that acknowledge the purpose of the programs"?

A. It is plural—programs.

Q. Okay.

MR. MARKHAM: Your Honor, we move the admission of Exhibit 1706.

MR. GREGORY: No objection, Your Honor.

THE COURT: Okay. It's admitted.

(The document referred to, previously marked for identification as Defendant's Exhibit 1706 was received in evidence.)

MR. MARKHAM: 742.

\* \* \* \* \*

[905] [Breiner—Cross] Q. Did this file—the information contained in it—add to your base of knowledge which you drew upon in evaluating the endowments insurance programs and in making recommendations to the board regarding them?

A. Well, I was certainly privy to the premiums that were offered by those big local buyers that we had brochures on. I don't—I don't recall wherever that any of the benefit levels or any of the provisions of those programs was in direct result—resulted in any direct change to any of our programs.

Q. Did it give you a knowledge of the general marketplace of what was being offered?

A. Oh, certainly, yes.

Q. Approximately what percentage of your staff devoted all or the majority of their time to running the insurance program?

A. Well, none of them ran the insurance program.

Q. Working on the insurance program.

A. I mean I was supposed to do that.

Q. What percentage of your staff devoted all or most of their time to working on the insurance programs?

A. I would say probably 80, 85 percent.

\* \* \* \* \*

[928] [Breiner—Cross] A. We're still having problems with the United States Government.

Q. In the—what's been marked as Exhibit 759, Mr. Zumbrook states in the committee meeting there was a certain air of pessimism over the current rates for both life and disability plans as being non-competitive. As you know, everytime we have seen a new offering of insurance on a mass basis to professional people, we have reviewed the rate structure for competitiveness. Is that an accurate statement?

MR. GREGORY: Objection. Competency.

THE COURT: Overruled.

THE WITNESS: I don't know when he says "we" if he was meaning he and I, or he and Rollings, Brigg and Hunter. I don't think that everytime a—some kind of an insurance program went out on a mass basis that we did a big statistical study on it.

BY MR. DENNIS:

Q. What about the next two sentences? As a rule the plans being compared are seldom the same as the ABE plans. However, we have never found that the ABE rates

were out of line to any degree which would cause your plans to be non-competitive. Do you agree with that statement?

A. Yes. I think I would agree to that as well as the next one that none of them offer a tax deduction.

[929] Q. I'd like to call your attention to what's been marked as Exhibit 648 and 1798.

THE COURT: I assume Mr. Rubloff is back at the office working on a response in the ABC case.

MR. DENNIS: He told me he was concerned about that, Your Honor.

THE WITNESS: I'm familiar with these two documents.

BY MR. DENNIS:

Q. You are. Would you identify them?

A. Exhibit 1798 is a letter to Mr. Joseph Gordon dated 1977 when he was treasurer of the American Bar Endowment to me with copies to other members of the Endowment Board relating to a group insurance program sponsored by the State—Washington State Bar Association in which Mr. Gordon had sent me previously asking me for my comments on that program.

Q. And Exhibit 648?

A. 648 is a letter from me again to Mr. Gordon dated October 8, 1980 thanking him for the booklet that he submitted to me from the American Business and Professional Trust and in which he asked me on September 26th if I would try to compare their coverage with our coverage.

Q. Did you receive requests from the board to make rate comparisons?

A. Yes, I would receive from time to time brochures on [930] various insurance programs, and they would ask me how does this compare with the endowment program.



Q. And would this be a typical response that you would make?

A. Well, not necessarily. It wouldn't be typical. It explains the differences between our program and this particular program. I mean it probably would be different depending upon the type of program and provisions and so on and so forth that might be involved with the other program. I would certainly reply to any inquiry that a director might make. I mean —

Q. Now, in the exhibit marked 1798, you state, "I am not too concerned with competition by the Washington State Bar as the Endowment is not only well-established but clearly recognized as administering its own insurance programs." Is that statement —

MR. GREGORY: Excuse me. Let the witness find the statement, please.

MR. DENNIS: Excuse me.

THE WITNESS: I've got the statement. I'm trying to find the answer. Yeah, I know the statement. I just wanted to see the brochure. Yeah. This is very good reply to the inquiry of Mr. Gordon, yeah.

\* \* \* \* \*

[1405] Whereupon —

HERBERT C. BROADFOOT

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MS. CARPENTER:

Q. Mr. Broadfoot, would you state your full name and address for the record?

A. My name is Herbert C. Broadfoot. My address is 364 Lake Forest Lane, Atlanta, Georgia.

MS. CARPENTER: In order to save time, I ask Mr. Broadfoot to state briefly his education, professional experience, his Bar Association memberships and his activities.

THE WITNESS: I was educated as an undergraduate Yale University. I graduated in 1966. I graduated from the Vanderbilt University School of Law with a J. D. Degree in 1969.

Following my graduation, I spent four years and four months on active duty in the Judge Advocate General's Court of the United States Navy. That was 1969 to 1973.

In 1973 I moved to Atlanta, where I joined the law firm of Stack & O'Brien for the general practice of law. I was with that firm for three years [1406] until 1976 when I moved to my present firm, Swift, Currie, McGhee & Hiers, a firm of approximately 36 attorneys in Atlanta.

I am a member of the State Bar of Georgia admitted in 1974. I am a member of the Tennessee Bar Association, admitted in 1969.

I am licensed to practice in all of the Courts of the State of Georgia as well as various Federal Courts, including the 5th and 11th Circuit Courts.

I am a member of the State Bar of Georgia which is our Bar Association there. I am a member of the Tennessee Bar Association as a nonresident member. I am a member of the American Bar Association and a member of the Atlanta Bar Association.

My practice is a specialty in bankruptcy and commercial law. In that capacity, as part of my practice, I am a member of the trustee panel for the Northern District of Georgia, practicing in the Bankruptcy Court for the Northern District.

In terms of my professional association memberships, I am a member of several sections of both the American Bar Association and the State Bar of Georgia, and I am presently the Vice-Chairman of the section on bankruptcy law for the State Bar of Georgia.

[1407] BY MS. CARPENTER:

Q. I understand that you are currently enrolled in the ABE life insurance program?

A. Yes.

Q. In the amount of \$50,000?

A. That is right.

Q. Did you have that same coverage in 1980 and 1981?

A. I did. I have had that coverage for a number of years.

Q. Directing your attention back to approximately 1980, how much life insurance coverage did you have at that time?

A. In 1980, I had approximately \$270,000 in face amount of life insurance coverage.

Q. Can you tell the Court how you came to enroll in the ABE insurance program?

A. I initially enrolled in the ABE insurance program in 1971. At the time I was in the Navy JAG Corps, a member of the ABA, and ABE as well. And I elected to take the coverage that was offered at that time, that was 1971. I was stationed in Great Lake, Illinois. My first child had recently been born and I was interested in obtaining some life insurance coverage at that time.

[1408] Q. Prior to enrolling in the ABE insurance program did you receive a brochure from the ABE?

A. Yes, I did.

Q. And did you read it?

A. Yes, I did.

Q. I am going to show you what has been marked as Exhibits 371 and 372 and ask you to identify them.

(The documents referred to were marked Defendants's Exhibit Nos. 371 & 372 for identification.)

(Document handed to witness by counsel Carpenter)

THE WITNESS: Exhibit 371 is an application form and enrollment form, and on the reverse side is a beneficiary

designation. These are forms that I completed at the time I applied for the insurance.

The Exhibit 372 is application for dependents' insurance, and a dependents' statement of health on the reverse side of that exhibit.

These forms both bear my signature and date of November 22, 1971.

BY MS. CARPENTER:

Q. Did you read these two applications before you signed them?

A. Yes, I did.

[1409] Q. At the time you signed these applications did you know what a dividend was in the sense of an insurance dividend?

A. Yes, I believe so.

Q. How did you know?

A. I had previously obtained some insurance from a private commercial insurance company and knew something about it at that time.

(The document referred to was marked Defendant's Exhibit No. 370 for identification.)

BY MS. CARPENTER:

Q. Next I am going to show you what has been marked as Exhibit 370 and ask you if you can identify it.

A. Exhibit 370 is an application requesting group life insurance from New York Life Insurance Company. This is a form that I completed and signed; my wife signed it as well on October 18, 1972.

Q. Was this form used to transfer you into the Plan D of the American Bar Endowment life program?

A. Yes. I note that Plan D is marked on the type of request. My recollection is that the program was revised.

When I look back at Exhibit 371, at that [1410] time it was called the Junior Plan and the Senior Plan, and then they had various units of the Maxi Plan. And I think in

1972 they revised it and labeled the different programs by schedule and then letters. So I think that Exhibit 370 is the transfer of my coverage to the new Schedule D program.

Q. Did you read this application before you signed it?

A. Yes, I did.

Q. Subsequent to enrolling in the ABE insurance program did you receive annual notices from the ABE disclosing what percentage of your premium payment was a contribution to the ABE?

A. Yes, I received an annual notice and it was in the form of a card that was mailed out each year.

Q. I show you what has been previously admitted in evidence as Exhibit 203 and ask you if this is the card?

(Document handed to witness by Counsel Carpenter)

THE WITNESS: This is the card for 1981.

MS. CARPENTER: Your Honor, I hand you Mr. Broadfoot's original, which he is contributing to the cause. You can keep this one. I think I didn't have an extra, at the time, of 1981, so that is why I [1411] brought Mr. Broadfoot's original in.

(The document referred to was marked Defendant's Exhibit No. 369 for identification.)

BY MS. CARPENTER:

Q. I show you what has been marked as Exhibit 369 and ask you if you can identify this document?

A. Exhibit 369 is a copy of six checks, personal checks drawn on my joint checking account at the First National Bank of Atlanta.

These are seminannual premium payments made to the American Bar Endowment in 1969, 1980 and 1981.

Q. Mr. Broadfoot, when you wrote these checks did you write them with the knowledge that a substantial portion of the amount paid would be a contribution to the Endowment for its work in the field of law?

A. Yes, I did.

Q. Mr. Broadfoot, why didn't you take a deduction on your tax return in 1981 for your contribution to the Endowment?

A. I was preparing my tax return at the last minute, as I unfortunately seem to do each year. And at the time that I was preparing that return I was unable to put my hands on the card that I subsequently [1412] located advising me of the amount of contribution I had made. And I also had some difficulty obtaining the checks so that I knew the precise amount involved.

The calculation becomes slightly complicated in that it pertains to an earlier period of time and it is necessary to gather these materials. As I say, unfortunately I had put it off until I ran out of time and I did file my return without claiming that deduction. I had claimed it in previous years.

Q. Have you had the occasion to review your Endowment policy with an insurance agent from another company?

A. Yes, I have.

Q. And did you also review your other coverage at that time?

A. Yes, I have.

Q. And did your insurance agent give you any advice with respect to your Endowment policy?

A. I have discussed all of my insurance coverage as part of a review of my insurance program, and I was advised by the insurance agent I consulted that the American Bar Endowment insurance program was more costly than the same coverage at his company or at other insurance companies. However, he recognized the contribution feature of this insurance coverage. [1413] That really was what we discussed when we reviewed the program.

Q. And why are you a Plaintiff in this action?



A. I was requested by one of my law partners to volunteer as a Plaintiff in this action, and I agreed to do so. I felt that the cause was right and I believed in the program. So I was willing to volunteer my time to this case.

MS. CARPENTER: Your Honor, I offer Exhibits 369, 370, 371, and 372 in evidence.

MR. MARKHAM: No objection, Your Honor.

THE COURT: They are admitted.

(The documents referred to, previously marked Defendant's Exhibit Nos. 369 through 372 for identification, were received into evidence.)

MS. CARPENTER: Your witness, Mr. Markham.

#### CROSS-EXAMINATION

BY MR. MARKHAM:

Q. Mr. Broadfoot, when did you first purchase Endowment life insurance?

A. Well—

Q. The year?

A. 1971.

Q. When you first enrolled in the Endowment's [1414] life insurance plan did you consider your out-of-pocket expenditure for the program to be outrageously overpriced in terms of the insurance you were receiving?

A. No.

Q. The same question for the period 1978 through 1981, did you consider your out-of-pocket expenditure to be an outrageously overpriced one for the insurance you received from the Endowment?

A. No, I did not.

Q. All things considered, would you consider your out-of-pocket expenditure for the insurance furnished by the Endowment to be a reasonable one?

A. I am not sure that I understand your question. Let me respond in this fashion:

I feel that when I make my payment, when I write this check to the American Bar Endowment it consists of two components. One component is the insurance coverage

aspect of it, and another component is the contribution that I am making to the American Bar Endowment.

So I am not sure whether your question was directed to the insurance component alone or to the total amount—

Q. To the insurance component.

[1415] A. Then would you repeat the question for me, please, as it relates to the insurance component?

Q. Would you consider your out-of-pocket expenditures for the Endowment's life insurance program a reasonable one in terms of the insurance coverage which you received?

A. Yes.

Q. Did you at one time also have coverage through the Georgia State Bar group insurance program?

A. Yes, I did.

Q. Do you recall how much life insurance you had through the Georgia State Bar?

A. I believe that was a \$20,000 program.

Q. And do you know which insurance company underwrote that plan?

A. I don't recall the insurance company.

Q. Do you recall that during your deposition on July 11 during your testimony you compared the semiannual premium rates for the Georgia Bar plan and for the American Bar Endowment's plan for \$20,000 coverage?

A. Yes, I do recall that.

Q. And do you recall what the results of that comparison were?

A. I think in general we found that the cost of [1416] the Georgia program exceeded the cost of the ABE program for the comparable amount of insurance.

Q. Would it refresh your memory as to the particular figures if I showed you your deposition on that point?

A. I am sure it would. I recall that we specifically went over the numbers involved.

MS. CARPENTER: I think it might be more helpful to show Mr. Broadfoot the figures. In other words, the policy from which he was figuring in his deposition.

MR. MARKHAM: Well, Your Honor, if there is no objection, I have not made sufficient copies of the other policy, and I think it would be quicker just to utilize the deposition. The witness indicated this would refresh his memory.

MS. CARPENTER: I have no objection to Mr. Markham reading into the record the questions and answers Mr. Broadfoot gave in that respect. That might be the quickest method.

MR. MARKHAM: It is somewhat lengthy, Your Honor.

THE COURT: What would you prefer to do, Mr. Markham?

MR. MARKHAM: I would prefer if Mr. [1417] Broadfoot could recall what we were referring to. It is at page 40 through 42.

THE COURT: Why don't you just thumb through, Mr. Broadfoot, to refresh your recollection.

MR. MARKHAM: I think you will find that the Exhibit 6 referred there to the Endowment literature and the Exhibit 4 was to the National Life of Canada policy.

(Deposition transcript handed to witness by Counsel Markham)

MS. CARPENTER: Is there a question pending?

MR. MARKHAM: Yes. As soon as he has finished reviewing the transcript of his deposition.

BY MR. MARKHAM:

Q. Mr. Broadfoot, under the two policies at the age of 30 were you able to refresh your recollection as to what the semiannual premium was?

A. Mr. Markham, it appears that it was \$36—the amount of the semiannual premium, age 30, for \$20,000 of coverage, that is the State Bar of Georgia program, and

I do recall now that it was National Life of Canada Insurance Company involved.

Q. And the American Bar Endowment's rate for that coverage at that age?

A. Semiannual premium contribution of \$25, for [1418] \$20,000 of coverage.

Q. And I believe that was for the age bracket 30 through 34; is that correct?

A. That is correct.

Q. Did the State Bar of Georgia plan pay dividends?

A. Not to my recollection.

Q. I think that is all we have on the deposition.

Now, did you terminate your coverage under the Georgia Bar plan due to the fact that you consider it to be too costly?

A. I did terminate my coverage under the State Bar of Georgia program as the result of some conversations and planning with an insurance agent.

Q. Do you still have your American Bar Endowment life insurance?

A. Yes, I do.

Q. And have you ever made any contributions to the Endowment, aside from your participation in the insurance program?

A. No, I don't believe that I have.

MR. MARKHAM: I would like to show you copies of three exhibits which have been marked 8002-A—four exhibits, excuse me. 8002-A through C and 837.

[1419] (The document referred to was marked Defendant's Exhibit Nos. 8002-A through C, and 837 for identification.)

BY MR. MARKHAM:

Q. Starting with 8002-A, can you recognize this as a group of promotional sheets received from the American Bar Endowment by you?

A. This exhibit is a copy of promotional material from the American Bar Endowment and I believe that I did receive this.

Q. Can you put a timeframe on when you might have received this?

A. It refers on page — well, it is the second copied page of the exhibit but it is marked page 3 and it refers to a current nonmedical enrollment period ending May 15, 1978. And also I note on the last page it refers to the American Bar Endowment's 36th year of existence. So I would suspect that this would have been sent out in 1978 prior to May 15. I believe the American Bar Endowment was established in 1942. So that would make it 1978.

Q. Turning to Exhibit 8002-B, the same question, did you receive this promotional packet from the Endowment?

A. Yes, I believe that I did.

[1420] Q. And I take it from the cover you would be willing to estimate that this was received in 1978?

A. Yes, I think we can agree on that.

Q. Turning to Exhibit 8002-C, do you recognize this as promotional material received from the Endowment?

A. Yes, I do recognize this as material sent by the ABE, and it is addressed to my former residence in Atlanta.

Q. And can you place a timeframe on this material?

A. I am trying to find a date on this one.

Q. In other words, you can't recall independently?

A. I can tell you that I lived at the mailing address shown on here until the latter part of 1978. So it would have been prior to that time.

Q. Finally, Exhibit 837. Do you recognize this as the brochure, or set of promotional materials received from the Endowment?

A. That is what it appears to be, but this refers to disability income, and I have not participated in the American Bar Endowment group disability income program. So I am not sure that I would have received this particular item.

MR. MARKHAM: Your Honor, we would moved that Exhibits 8002-A, B, and C, be received in evidence.

MS. CARPENTER: No objection.

THE COURT: They are admitted.

(The documents referred to, previously marked Defendant's Exhibit Nos. 8002-A, B & C for identification, were received into evidence.)

MR. MARKHAM: No further questions, Your Honor.

THE COURT: Anything else?

MS. CARPENTER: Yes, Your Honor, one question.

#### REDIRECT EXAMINATION

BY MS. CARPENTER:

Q. Mr. Broadfoot, you were quoted in the Government's Memorandum of Contentions of Fact and Law, and I noted Mr. Markham used a phrase you were quoted as using in his cross-examination. The quotation in the Government's brief without citation is "Question: Just as a general statement, as you sit here today having purchased several types of life insurance knowing what you know, would you characterize the ABE rates you are paying as reasonable?"

Your answer: "All things considered, yes."

[1422] My question to you now is when you referred to the things considered, what things were you considering?

A. I considered several factors. The cost of the insurance itself. The contribution feature of the American Bar Endowment program, and what I would call some subjective considerations such as a notion that I was participating through my professional association, the



American Bar association and the Endowment. So I think that when I gave that answer, those were the factors that I was considering.

MS. CARPENTER: No further questions, Your Honor.

MR. MARKHAM: No recross, Your Honor.

THE COURT: Mr. Broadfoot, thank you for your testimony. You are excused.

(Witness excused)

MS. CARPENTER: Mr. Turner, would you take the seat in the witness stand. Or actually, remain standing until Judge Kozinsky administers the oath. Whereupon—

FREDERICK D. TURNER

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MS. CARPENTER:

Q. Mr. Turner, would you state your name and address for the record, please?

A. Frederick D. Turner, I reside at 34 Sunset Lane, Orchard Park, New York.

Q. That is in the Buffalo area?

A. Yes, it is.

Q. Would you kindly give the Court a brief statement of your education, professional experience and Bar Association memberships and activities?

A. Yes. I graduated from Dartmouth College in 1958. After a few years in the Armed Services, I graduated from Cornell Law School in 1963, was admitted to practice in the State of New York in 1963. Also in the District Court of Western New York and in the United States Court of Appeals for the Second Circuit. I am a member of the Erie County Bar Association, the American Bar Association. I was formerly a member of the New York State Bar

Association several years ago. And within the American Bar Association I am a member of the Fidelity Surety Committee of the Negligence and Insurance Section. Also a member of the Construction Forum Committee and the Government Contracts Committee.

I am also a member of the International [1424] Association of Insurance Council and in particular their Fidelity & Surety Committee. And I specialize basically in construction and surety law.

Q. Do you continue to be eligible for membership in the New York State Bar Association?

A. I do not.

Q. You do or don't?

A. I do not at this time.

Q. Are you eligible for membership?

A. I assume I am.

Q. I want to show you what has been marked as Exhibit 376 and ask you if you can identify it.

(The document referred to was marked Defendant's Exhibit No. 376 for identification.)

MS. CARPENTER: What I show Mr. Turner, Your Honor, is Mr. Turner's original 1972 brochure which he has saved and what I hand Your Honor is our file copy of that brochure.

THE COURT: Thank you.

THE WITNESS: Yes, this was a brochure I received sometime in the fall of 1972 from the American Bar Endowment relating to a group life insurance program.

BY MS. CARPENTER:

[1425] Q. And are you currently enrolled in the ABE group life insurance program?

A. Yes, I am.

Q. Did you receive that brochure prior to enrolling in the program?

A. Yes, I did.

Q. I am going to show you what has been marked as Exhibit 378 and ask you if you can identify it?

(The document referred to was marked Defendant's Exhibit No. 378 for identification.)

THE WITNESS: That is a photocopy of an application requesting group life insurance from New York Life Insurance Company on an American Bar Endowment form. And that is a copy, albeit rather faint, of my signature.

BY MS. CARPENTER:

Q. Did this application accompany Exhibit 376?

A. I believe it did.

Q. Did you read the brochure and the application before signing the application?

A. It is my practice to do so, and to the best of my recollection, I did so.

Q. Directing your attention for a moment to the years approximately 1979-1980, how much life insurance [1426] did you have at that point?

A. Including term, declining term on a house mortgage, I would say between 90 and 100,000, approximately, at that time.

Q. And how much ABE insurance did you have and do you have?

A. 20,000.

Q. You have been enrolled continuously since 1972?

A. Yes.

Q. When you enrolled did you know what an insurance dividend was?

A. Yes, I did.

Q. How did you know that?

A. From my other policies that I have had, and I think through general knowledge. At that time I enrolled I had policies with Provident Mutual and Berkshire Life Insurance. And some of those policies I had either the option to reduce premiums or to keep the premiums in and get

some additional life insurance. I think I did one for each one, if I recall.

Q. Those are both mutual insurance companies?

A. Yes.

Q. Subsequent to enrolling in the ABE insurance program did you receive annual notices from the [1427] Endowment disclosing what percentage of your premium payment was a contribution to the Endowment?

A. Yes, I did.

Q. I am going to show you what has been marked as Exhibit 379 and ask you if you can identify it.

(The document referred to was marked Defendant's Exhibit No. 379 for identification.)

THE WITNESS: Exhibit 379 consists of copies of various checks drawn upon my personal account payable to the order of American Bar Endowment, and they represent semiannual premiums toward the life insurance program that is spelled out in the brochure.

BY MS. CARPENTER:

Q. When you made the payments reflected in Exhibit 379 did you do so with the knowledge that a substantial portion of your payment would be a contribution to the Endowment for its work in the field of law?

A. Yes. At this time I had received a number of notices from the American Bar Endowment which had advised me at various times—I think it was on an annual basis, as to the amount of the dividends which were then used as a contribution to American Bar Endowment.

[1428] Q. I am going to show you what has already been admitted in evidence as Exhibit 202 and ask you if that is the notice you received for 1980?

A. I believe I received this probably 1981, but I think it related to 1980. But I did receive this in the mail from the American Bar Endowment.

MS. CARPENTER: Your Honor, this has been admitted in evidence but I am not sure we had an original for you at that time.

(Exhibit handed to His Honor by Ms. Carpenter)

BY MS. CARPENTER:

Q. Mr. Turner, why didn't you take the deduction for the tax year 1980?

A. I believe based upon a portion of the written notice, it had advised that the Internal Revenue Service had taken the position that the contributions that were made to the American Bar Endowment representing my proportion at dividend on my insurance program was not going to be allowed as a tax deduction. I decided that I was not going to take it. At that time I figured I did not need the hassle.

Q. Why did you become a Plaintiff in this action?

A. I suppose I wasn't very well-educated.

[1429] No, the reason I did, I disagreed with the position of the IRS, but I was requested if I would be willing to sort of be a test case as far as the Internal Revenue Service position was concerned. I feel that there are certain obligations that when I disagree with the position of the IRS and when I think it is for the benefit of the Bar Association and fellow lawyers, I felt it was an obligation on my part to be a party to this action.

MS. CARPENTER: Your Honor, at this time we offer Exhibits 376, 378, and 379 in evidence.

MR. MARKHAM: No objection, Your Honor.

THE COURT: They are admitted.

(The documents referred to, previously marked Defendant's Exhibit Nos. 376, 378 & 379 for identification, were received into evidence.)

MS. CARPENTER: Your witness, Mr. Markham.

CROSS-EXAMINATION

BY MR. MARKHAM:

Q. Mr. Turner, when did you first enroll in the Endowment's life insurance program?

A. The application, Exhibit 378, shows the application dated October 1982. It would have been sometime thereafter, shortly thereafter.

[1430] Q. At the time you applied for enrollment in the Endowment's life insurance plan did you feel that it was a good program that fit your needs for insurance?

A. At that time I felt it was a program that I was interested in and I followed through with it.

Q. Were you eligible at any time for enrollment in the New York State Bar life insurance plan?

A. Yes.

Q. Did you ever enroll in that plan?

A. I never did.

Q. Aside from your participation in the Endowment's insurance programs, have you made any other—or have you made any contributions to the Endowment?

A. Well, when you say contribution, I think not necessarily a monetary contribution as such, but I think I have given time to the American Bar Association activities, and it is hard to say where the American Bar Endowment and where the American Bar Association begin and leave off.

Q. No other financial participation?

A. I have not been asked to give anything other than my dividends to their purposes.

MR. MARKHAM: No further questions, Your [1431] Honor.

MS. CARPENTER: No redirect, Your Honor.

THE COURT: Thank you, Mr. Turner, you are excused.

(Witness excused)

MS. CARPENTER: Mr. Sherwood, Your Honor. Whereupon—

ARTHUR M. SHERWOOD

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MS. CARPENTER:



Q. Mr. Sherwood, would you state your name and address for the record, please?

A. My name is Arthur M. Sherwood. I live at 3770 Windover Drive, Hamburg, New York.

Q. That is in the Buffalo area?

A. That is correct.

Q. Would you briefly give the Court a statement of your education and professional experience, your Bar Association memberships and activities?

A. Yes. I am a graduate of Harvard College and University of Michigan Law School. After law school I served as law clerk to Judge Freeman of the Eastern District of Michigan for two years. I then [1432] worked for the Buffalo law firm of Phillips, Lytle, Hitchcock, Blaine & Hubert, where I have been a partner since 1971. I specialize in trust and estate work. I am a member of the American Bar Endowment, New York Bar Association and Erie County Bar Association. I am a fellow of the American College of Probate Counsel and also a member of the Executive Committee of the New York State Bar Association Trust and Estate Section.

Q. When you—have you ever belonged to the New York State Bar insurance program?

A. Yes, in the 1960s I had some group term life insurance from that program.

Q. Is that a charitable program?

A. I think not.

Q. And are you currently enrolled in the ABE life insurance program?

A. Yes.

Q. And how long have you been in that program?

A. Since April of 1972, I believe.

Q. How much insurance do you have with the ABE insurance program?

A. At the present time?

Q. Yes.

A. I have \$20,000 of coverage on my life and [1433] \$5,000 of dependent coverage.

Q. Directing your attention back to the period around 1979, 1980, about how much life insurance did you have?

A. All together I had roughly \$320,000 of basic life insurance coverage including the American Bar coverage. I also had accidental death coverage of an additional 130,000 and an additional 190,000 or so for death on common carrier. Total of roughly \$640,000 if I were to die in that fashion.

Q. Can you tell the Court how you came to enroll in the ABE insurance program?

A. I received some literature in the mail to which I responded.

Q. I show you a document that has been marked as Exhibit 359 and ask you if you can identify it?

(The document referred to was marked Defendant's Exhibit No 359 for identification.)

THE WITNESS: The little brochure you just handed the Court is a document I received from the American Bar Association in 1972.

BY MS. CARPENTER:

Q. Did you read that brochure before you enrolled in the program?

[1434] A. Yes.

Q. I am going to show you what has been marked as Exhibit 356 and ask you if you can identify it?

(The document referred to was marked Defendant's Exhibit No. 356 for identification.)

THE WITNESS: This document is a Xerox copy of my enrollment. The beneficiary designation. And also the check I paid for the initial premium.

BY MS. CARPENTER:

Q. What was the amount of that check?

A. \$7.50.

Q. I am going to show you what has been marked as Exhibit 353 and ask you if you can identify that?

(The document referred to was marked Defendant's Exhibit No. 353 for identification.)

THE WITNESS: This was the enrollment form for dependents' insurance which I signed and submitted to the American Bar Endowment in June of 1972.

BY MS. CARPENTER:

Q. Prior to signing and sending in Exhibits 353 and 356 did you read them?

A. Yes.

Q. And did there come a time later, Mr. [1435] Sherwood, when you increased your coverage in the American Bar plan?

A. Yes.

Q. What had been your prior coverage and what is your current coverage?

A. Well, when I purchased the American Bar Endowment insurance for myself in 1972 I think the initial coverage was \$8000, I believe, at my age at the time. In 1978 I increased my coverage, and the amount went to \$20,000. And in 1979 when I increased the dependent coverage it went from \$2500 to \$5000.

Q. When you signed these applications did you know what a dividend was on an insurance policy?

A. Yes.

Q. How did you know?

A. Well, through some familiarity with life insurance generally and also in particular from a policy that I held myself from the Northwestern Mutual Insurance Company, which I had purchased before 1972.

Q. Subsequent to enrolling in the ABE insurance program did you receive annual notices from the Endowment that disclosed what percentage of your premium payment was a contribution to the ABE?

A. Yes.

Q. Mr. Sherwood, I am going to ask you to [1436] identify Exhibits 357 and 358.

(The documents referred to were marked Defendant's Exhibit Nos. 357 & 358 for identification.)

THE WITNESS: These are Xerox copies of checks I sent to the American Bar Endowment between December 1978 and December 1981 representing the premium payments for the coverage that I had on myself and my dependents.

BY MS. CARPENTER:

Q. Mr. Sherwood, when you sent the checks to the Endowment that are reflected in Exhibits 357 and 358, did you do so with the knowledge that a substantial portion of that payment would be a contribution to the ABE for its work in the field of law?

A. Yes.

Q. Mr. Sherwood, is the exhibit which I am handing you which has previously been admitted as Exhibit 203 a copy of the notice you received for 1981 with respect to the deductible portion of your premium payment?

A. I think this is the document that I did receive. The original.

Q. Why didn't you take the deduction in 1981? [1437] A. Well, as this document indicates, the Internal Revenue Service in 1980 had ruled that insured members could not treat as charitable deduction the premium refunds they contributed. This posed to me some question about the deductibility and I elected not to claim it.

Q. Why did you become a Plaintiff in this action?

A. Because I wanted to. I thought that this was a matter that ought to be clarified. I felt that this amount was either deductible or wasn't and it should be subject to determination if there is some controversy and I was willing to be a Plaintiff to help resolve that issue.

MS. CARPENTER: Your Honor, we offer Exhibits 357, 358, 353, 356, and 359 in evidence.

MR. MARKHAM: No objection, Your Honor.

MS. CARPENTER: I can give you that in a better order. 353, 356, 357, 358 and 359.

THE COURT: They are admitted.

(The documents referred to, previously marked Defendant's Exhibit Nos. 353, 356, 357, 358 & 359 for identification, was received into evidence.)

MS. CARPENTER: Your witness, Mr. Markham.

[1438] CROSS-EXAMINATION

BY MR. MARKHAM:

Q. Mr. Sherwood, I believe you testified you were eligible for New York State Bar life insurance program. Did you enroll in that program?

A. I enrolled in it sometime in the 1960s, and I later let my coverage lapse.

Q. Do you know when you let your coverage lapse under that plan?

A. I think it was before 1971 when I became a partner with the firm. The reason being that at that point I acquired additional group term coverage with the firm that I did not enjoy as an associate and I did not feel the need for the state bar coverage at that time.

Q. When you enrolled in the Endowment life insurance program in 1972 did you already have coverage for life insurance under your law firm's group policy?

A. Yes.

Q. Did you increase the amount of your American Bar Endowment life insurance coverage in 1978?

A. Yes.

Q. And did you increase the amount of your dependent coverage under that program in 1979?

[1439] A. Yes.

Q. Have you purchased credit life insurance in the past?

A. Credit life? I don't believe I know what you are referring to.

Q. As part of a loan application did you finance a mortgage either on a house or car or something where there was a life insurance contract in association with that which would pay the loan balance in case you died?

A. I don't believe I have ever done that.

MR. MARKHAM: No further questions, Your Honor.

MS. CARPENTER: No redirect, Your Honor.

THE COURT: Mr. Sherwood, thank you for your testimony. You are excused.

(Witness excused)

Whereupon—

FREDERICK G. BOYNTON

a witness, called for examination, having been first duly sworn, was examination and testified as follows:

DIRECT EXAMINATION

MS. CARPENTER:

Q. State your name and address for the record, please?

[1440] A. Frederick G. Boynton, 4860 North Way Drive, Northeast, Atlanta, Georgia.

Q. Mr. Boynton, would you please state briefly for the Court your education and professional experience, your Bar Association memberships and activities?

A. I received a Bachelor of Arts Degree from the Citadel in 1970. I received a J. D. from Tulane University School of Law in 1973. From 1973 until 1976, I served in the United States Army Judge Advocate General's Corps.

My first assignment was Falls Church, Virginia, as a defense appellate attorney and I represented soldiers who had been convicted in courtmarshal in their appeals to the United States Court of Military Review and the United States Court of Military Appeals.

After that I transferred to Fort McPherson in Atlanta where I was legal assistance officer for 13 months. In October of 1976 I became an associate at the law firm now



known as Gambrell & Russell in Atlanta. I became a partner in that firm in July of 1982.

I am a member of the South Carolina Bar, the State Bar of Georgia, the Federal Bar Association, the [1441] Atlanta Bar Association, the Lawyers' Club of Atlanta and the American Judicature Society; fairly active in the Federal Bar Association. During 1981 and 1982 I served as President of the Atlanta Chapter of the Atlanta Bar Association and I am currently on the Executive Committee of the Federal Bar Association, Atlanta Chapter, and for the last three years on the Board of Directors of the Younger Lawyers Divisions of the Federal Bar Association.

Q. I am going to show you a document that has been marked as Exhibit 380 and ask you if you can identify it?

(The document referred to was marked Defendant's Exhibit No. 380 for identification.)

THE WITNESS: This is a copy of the application I filled out when I applied for a disability insurance policy through the American Bar Association.

BY MS. CARPENTER:

Q. Before you signed the application, did you read it?

A. Yes, I did.

Q. And before you signed the application did you review a brochure with respect to the disability [1442] program that was sent to you by the Endowment?

A. Yes.

Q. Did the brochure disclose the charitable purposes of the plan?

A. It did.

Q. Did you throw away that brochure?

A. I did not save it. Yes.

Q. At the time you signed this application did you know what a dividend or experience credit was?

A. Yes, I had several other insurance policies that paid dividends and I understood that a dividend was based upon the claims experience the company had. So I did understand it.

Q. Subsequent to enrolling in the ABE disability program, did you receive annual notices from the Endowment that disclosed what percentage of your premium payment was a contribution to the ABE.

A. Yes, I received one each year, including one for 1981.

Q. I am going to show you what is already in evidence as Exhibit 202 and ask you if that is the notice that you referred to?

A. This is a notice similar—well, identical to those notices I received. I don't know what year this is for.

[1443] Q. That is a Xerox?

A. Right.

Q. I am going to show you what has been marked as Exhibit 382 and ask you if you can identify that Exhibit?

(The document referred to was marked Defendant's Exhibit No. 382 for identification.)

THE WITNESS: These are copies of five checks of mine; four of them are for semiannual premiums that I paid for my disability insurance through the American Bar Association for the years 1980 and 1981. And the fifth check is a check I paid to Eastern Airlines for membership in its Ionosphere Club for 1981.

BY MS. CARPENTER:

Q. Did you also make similar payments to the Endowment in 1979?

A. Yes, I did.

Q. When you made the 1979 payments and the payments to the Endowment that are reflected in Exhibit 382, did you do so with the knowledge that a substantial portion of the payment would be a contribution to the American Bar Endowment for its work in the field of law?

[1444] A. Yes, I did.

Q. Mr. Boynton, why didn't you take the deduction in 1981?

A. The notice that I received from the American Bar Association for that year said that the Internal Revenue Service had ruled that members could not deduct, as a charitable contribution, that portion of the premium that represented a charitable contribution and, therefore, I did not think that I would do it for that year since I didn't want to litigate at that time with the IRS.

Q. Why did you become a Plaintiff subsequent to that?

A. When I found out that the American Bar Association was challenging the IRS ruling and was offered an opportunity to participate in litigation I did so, because I believed the IRS was wrong.

Q. The second page of Exhibit 382 is a check to the Eastern Airlines Ionosphere Club. Can you tell me what that represented?

A. It represented my membership dues for 1981 to the Ionosphere Club. That club provides lounges in airports for use of the members. The only traveling I did by air in 1981 was for business purposes and I tried to use my time efficiently so what I do is take [1445] work and when I have extra time in airplanes I work in the Eastern Ionosphere Club Lounge.

MS. CARPENTER: Your Honor, because Mr. Boynton has a claim in addition to his American Bar Endowment claim I am going to have him identify his claim for refund as well and explain the two claims. It is Exhibit 183.

(The document referred to was marked Defendant's Exhibit No. 183 for identification.)

THE WITNESS: Exhibit 183 is the Power of Attorney that I signed, an amended income tax return for the tax year 1981, and a narrative explanation of claim for refund that I filed.

MS. CARPENTER: I offer Exhibits 380, 382 and 183 in evidence, Your Honor.

MR. MARKHAM: No objection, Your Honor.

THE COURT: They are admitted.

(The documents referred to, previously marked Defendant's Exhibit Nos. 380, 382 & 183 for identification, were received into evidence.)

MS. CARPENTER: Your witness, Mr. Markham.

#### CROSS-EXAMINATION

BY MR. MARKHAM:

[1446] Q. Did you apply for your American Bar Association disability insurance in 1978, Mr. Boynton?

A. I did.

Q. Prior to purchasing this insurance had you surveyed or looked at a number of other disability income insurance plans that were available to you?

A. Yes, I did.

Q. Have you received promotional literature from the American Bar Endowment on various occasions?

A. I have.

Q. I would like to show you two exhibits, which are 840-A and 8001-A.

(The documents referred to were marked Defendant's Exhibit Nos. 840-A & 8001-A for identification.)

BY MR. MARKHAM:

Q. I would ask you if you can recognize these as copies of literature that you received from the Endowment?

A. I don't recall one way or the other whether I received a copy of Exhibit 840-A. And I don't specifically recall whether I received a copy of 8001-A, but both documents are similar to the type of promotional material I have received from the American Bar Association over the last five or six years.

[1447] MR. MARKHAM: Your Honor, I believe both of these documents were included in Mr. Boynton's responses to interrogatories, and I ask the Plaintiff if they would be willing to stipulate that these were documents received by Mr. Boynton from the Endowment?



MS. CARPENTER: I will accept Mr. Markham's representation that they were attached to the Answers to Interrogatories, and given that they were attached I would be willing to stipulate that he received them.

MR. MARKHAM: We would offer Exhibits 840 and 8001 — excuse me, that is 840-A and 8001-A into evidence, Your Honor.

MS. CARPENTER: No objection, based on Mr Markham's representation.

THE COURT: They are received.

(The documents referred to, previously marked Defendant's Exhibit Nos. 840-A & 8001-A for identification, were received into evidence.)

BY MR. MARKHAM:

Q. Did you receive the impression, from reading the promotional literature, Mr. Boynton, that the Endowment sent you regarding their disability insurance plan, that the cost for that insurance coverage was reasonably and competitively priced?

[1448] A. It is difficult for me to answer that. The other policies that I looked at were individual policies offered by Paul Revere Insurance Company and the Equitable.

I do recall also looking at some promotional material from the Federal Bar Association and a group plan but I didn't save that material and I have no present recollection of the terms offered. The other two policies I looked at were more expensive but they had considerably greater benefits than the one offered by the American Bar Association.

Q. Your testimony now is that you cannot form an opinion as to whether, from reading the Endowment's promotional material, you received the impression that the disability insurance plans they were offering were reasonably or competitively priced?

A. I think today they are reasonably and competitively priced, yes.

Q. How about in the periods 1978 through 1981?

A. I don't think I really thought about it at that time. I was satisfied with the policy that I had, it provided the coverage I wanted at a price I was willing to pay and had the added feature of a charitable contribution in the field of law.

Q. I am showing you a copy of your deposition [1449] conducted July 22, 1978, and I ask you to read the questions and answers beginning on page 14 regarding the timeframe 1978 through the present.

A. "Have you received and read the literature sent you by the American Bar Endowment concerning their disability plans, that is promotional literature.

"ANSWER: During what periods of time?

"QUESTION: Beginning in 1978 through the present.

"ANSWER: Yes.

"QUESTION: Did you receive the impression from reading that literature that the American Bar Endowment disability insurance plans were reasonably or competitive priced?

"ANSWER: Yes.

"QUESTION: Forgetting about the literature and just based on your knowledge"—

Q. That is sufficient. Do you recall that testimony?

A. Yes, I do.

Q. Do you have any reason to change your mind about the period 1978 through the present?

A. No.

Q. Aside from your participation in the Endowment's insurance programs, have you made any [1450] financial contributions to the Endowment?

A. Yes, I have.

Q. What were those?

A. Well, I should qualify that. I made several contributions. Whether it was to the American Bar Association or the American Bar Endowment, I don't recall



specifically. I do recall making two contributions, one was to the Second Century Fund, and I don't recall the other one specifically.

But then, of course, every year I have made a contribution through my participation in the disability insurance program.

MR. MARKHAM: No further questions, Your Honor.

MS. CARPENTER: Your Honor, I do just want to clarify a mistake that I made on direct, which was to show Mr. Boynton Exhibit 202 and ask him if that was not the 1981 notice. But 202 is the 1980 notice, so now I want to show him Exhibit 203 and ask him if that is not in fact the 1981 notice. I want the record to be clear.

(The document referred to was marked Defendant's Exhibit No. 203 for identification.)

THE WITNESS: Yes, that is the copy of the [1451] exact notice I received saying 28 percent of my insurance premium was deductible.

MS. CARPENTER: No further questions, Your Honor.

THE COURT: Mr. Boynton, thank you for your testimony. You are excused.

(Witness excused)

THE COURT: We will take a five minute break.

(Witness excused)

(Brief recess)

MS. CARPENTER: Our next witness is Mr. Kenneth J. Burns, and he is President of the American Bar Association.

Whereupon —

KENNETH J. BURNS

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MS. CARPENTER:

Q. Mr. Burns, would you state your full name and address for the record, please.

A. Kenneth J. Burns, Jr. My home address is 115 Fuller Lane, Winnetka, Illinois.

Q. Would you give the Court a short statement with respect to your educational background, your work [1452] experience, and your ABA and ABE service?

A. I graduated from the Northwestern University School of Law in 1951. After a short stint in the Navy I became employed and started work with a law firm in Chicago called Johnston, Thompson, Raymond and Mayer. I became a partner in that firm, but left the firm in 1972 to assume the position of Vice-President and General Counsel of the Anchor Hocking Corporation in Lancaster, Ohio.

In 1979 I became Vice-President General Counsel of International Minerals and Chemical Corporation in Northbrook, Illinois.

Over the course of those years I was active in the Chicago Bar Association, including some service on their board of managers, doing some committee work with the Illinois State Bar Association, but beginning in the late 1950's more active, I think, in the American Bar Association where at first in the Junior Bar Conference where I became Chairman of the Conference in the early 1960s, and then as the delegate from the Conference in the House of Delegates of the ABA, and then in the mid 1960s I was appointed the Assistant Secretary of the ABA in which I served until 1971 when I was elected Secretary of the ABA and became a member of the Board of Governors.

[1453] I was in that position until 1975. And it was in 1975 when I was elected to the Board of Directors of the American Bar Association.

Throughout that period since 1975 I have remained a delegate in the House of Delegates of the ABA and I have been active on some committees of the ABA. Then, of course, my work with the American Bar Association has included in addition to being a member of the board work

on various committees of the Endowment. At one time or another I have been Chairman of the Audit Committee, the Grants Committee, the Insurance Committee. I think I have always been on the Investment Committee.

At the present time I am President of the American Bar Endowment having assumed that office in August of this year. Prior to that time for two years I was Vice-President of the Endowment.

Q. Thank you, Mr. Burns. How large is the American Bar Association board?

A. Ten people.

Q. And who makes up the board, what kind of people are on the board?

A. The members of the board are elected by the membership, each for a term of five years over staggered terms. And they are—well, present [1454] company excepted, I think you would describe them as successful legal practitioners who are well-known in general in the profession.

Q. And do they typically have an American Bar Endowment background?

A. I can think of no exception to that. Many, if not all of them, have been very active in the ABA.

Q. Can you estimate the average amount of time contributed by a board member to the work of the Endowment during a typical year?

A. It would be substantial. I would estimate probably eight to ten days a year are actual meetings, or going to meetings, and then there would be another ten to twenty days of work customarily I would think that would be involved outside of meetings.

Q. And that would depend on what committees you are on?

A. Yes.

Q. Are most of the members of the board in the private practice of law with law firms?

A. Yes, the only exception presently, I think Bert Early, who was a newly elected director, has not been in private practice for a number of years. His background is basically as the Executive Director of the ABA, a position he no longer holds, but that is [1455] the experience factor and reputation factor that I think led to his election.

Q. What is the function of the Board of Directors of the Endowment?

A. The board is charged with managing the affairs of the Endowment.

Q. Do the members of the board actually manage the affairs of the Endowment?

A. Well, on the policy level, yes. And sometimes even in some correspondence. But the day to day manning of the work of the Endowment is done by the employed staff.

Q. You mentioned several committees. What is the function of these committees?

A. In their particular area the Grants Committee, for example, is charged with making whatever studies and investigations there might be necessary to determine worthy beneficiaries of grants from the Endowment. And in holding meetings at which applicants for grants would appear and present their case.

And then finally reviewing those and making recommendations to the board with respect to the grants that should be made by the Endowment.

\* \* \* \* \*

[1458] Q. During your tenure on the Insurance Committee what was your philosophy with respect to the rates that ought to be charged in the ABE insurance programs?

A. Well, speaking as one member of the Insurance Committee, my philosophy, if you will, was that the purpose of the Endowment's program, of which insurance is a part, was to raise funds, it was a fund raising program. And the funds that were raised necessarily depended upon



the, among other things, there were other sources but primarily, on the rates that were charged for participation in the insurance program.

Those rates had to be, in my view, at a level that would result in a significant annual return of dividend or contribution refund that would provide the Endowment with the wherewithal to carry out its purposes.

Q. During the years in issue, did you have difficulty with any of the programs in terms of [1459] generating substantial dividends?

A. Yes. Yes, there were two, as I recall.

Q. What were those two programs?

A. Well, in the accidental death and dismemberment program, called the ADD-250, I believe, in the first year the experience was very extremely—well, let's say it was bad, in the sense that there was no refund contribution return from Mutual of Omaha. The experience was that bad. And we were very seriously considering whether we made a mistake and maybe we would have to drop that program.

The second area where a problem arose in we were not receiving the refund contribution that we thought we needed to get, wanted to get, was I believe in the major medical program where the inflation in medical cost got ahead of us, and we had to raise the rates rather significantly on two occasions that I remember in an effort to produce the level of overall premium payments that coupled with the experience would result in a refund contribution.

Q. Did the board consider dropping these two programs?

A. Yes. Yes.

Q. Why weren't they dropped?

A. Well, in the case of the ADD-250, Mutual's [1460] reaction to the experience that we had encountered was that this was in the nature of an aberration and was not

likely to recur. And in fact time has proved out their judgment, we kept the program and the program has produced significant refund contributions.

Q. Talking about refund contributions since the years in issue?

A. Since—well, I am not certain which.

Q. Fiscal 1981 is our last year in issue.

A. I think the problem would have occurred in the sense that we had no dividend in one year occurred during the years in issue. Since then there has been a significant refund contribution, so there has been no thought since then of dropping or changing the program.

Now, major medical, all we have done is raise rates although we have considered the fact that if that did not work then we would have to consider dropping the program.

Q. Is that program still under review? Major medical, that is.

A. I think it is, yes.

Q. I am going to show you what was admitted into evidence as Exhibit 380, which is an application form for the disability program. I want to point out [1461] some language to you on the application. In the middle where it says "I understand and agree," and it indicates that under subpart D that "any experience credits apportioned to the group policy shall be payable to the American Bar Endowment and are contributions from the participants." Do you see that?

A. I see that.

Q. Has that language always been on the enrollment form?

A. To my knowledge it has substantially to that effect. I don't know whether there has been any change in the actual words used, but in substance, yes.

Q. Can you tell the Court why that language is on the enrollment form?



A. Well, I think it is there because the money that is paid as a result of this enrollment and the others like it, is the money of the members, and they must agree as to what that money is to be used for.

Q. And do you know whether that is the view of the other members of the board?

A. I believe it is. I have not heard any different view.

Q. What happens if an enrollment form comes in with that language struck out, crossed out by the member?

[1462] A. That happened only once that I know of, and in that particular case it was not discovered until after the member had been in the program for a year.

Q. What if it had been discovered when the enrollment form came in?

A. If discovered when the enrollment form was received by the Endowment it would not have been accepted, it would have been returned to the applicant.

Q. This particular one as you are referring to was not discovered?

A. It was not discovered until the member pointed out why he did not get a refund instead of the notice of the amount that he could claim as a deduction if he wished.

Q. And what did the board—did the board consider this question?

A. Well, at that time I think I was chairman of the Insurance Committee, and I think I had to work that out.

Q. Did the board feel some obligation to this member?

A. Well, the board's policy was quite clear. If you were to be in the program you had to be in the program on the same terms as everyone else who was in the program and here we have an instance of a member [1463] who was in the program for a year on different terms unbeknownst to us and we felt we had to change that.

So we gave him an option, he could continue in the program, but if he did so he would have to continue on the same terms as everyone else.

Q. Did you make an accommodation to that member with respect to that year that he had been in the program without an assignment of dividends?

A. We felt we had to. We felt that he had made a mistake, but also we had made a mistake so we felt we had to accommodate him for that one year.

Q. After the Endowment pays its expenses, what happens to the rest of the money that is returned as dividends and experienced credits?

A. Well, for the most part it will be paid out annually in the form of grants to entities that are qualified to receive grants from the Endowment, such as the Fund for Public Education of the American Bar Association, the American Bar Foundation, National Legal Aid and Defender Association, and many others over the period of time.

From time to time some of the refund contributions are added to the investment fund, or reserve, of the Endowment and held, reinvested, producing income which is then applied for either [1464] expenses or grants, and on occasion then grants have been made from the investment or reserve fund. Best example there would be in the earlier years when monies were taken from the investment funds for the construction of additions or improvements to the Bar Center in Chicago.

Q. Does the board recognize any obligation with respect to the premium contributions that are received from members?

A. Oh, yes.

Q. And what is that obligation?

A. Well, those funds that are received where the members pay their statements must be held and applied solely to be paid to the insurance companies to provide the insurance.

Q. Does the board recognize any obligation with respect to the dividends and experience credits that are received?

A. Oh, yes.

Q. And what is that obligation?

A. Those funds, the refund contributions, must be applied in accordance with the charter provisions governing the Endowment, its purposes.

Q. Have you ever received a complaint from a member that he or she did not understand the [1465] charitable purpose of the program?

A. Oh, I don't think that they didn't understand it. I think the only thing even bordering on that would be a complaint that although they understood it they wish we would change it and simply provide the lowest cost insurance.

Q. During the years in issue did the board receive a proposal from James Group Service, Inc., to administer the insurance programs of the Endowment for about a million dollars a year?

A. Yes.

Q. And was that proposal considered by the board?

A. Yes.

Q. And was it accepted or rejected?

A. It was rejected.

Q. Would you explain to the Court why it was rejected?

A. Well, speaking as one board member at the time, my recollection, and certainly among my reasons was, first of all, if we had accepted it it would have meant we would have had to disband our staff and henceforth we would be really a captive of the outside administrator. And there was really no guarantees that the cost over time would not be increased, so [1466] that it would really be no different than if we had maintained our own staff. So there was really no guarantee that over time we would have saved money.

And second, and I think probably more important, if we had disbanded our staff and had gone to an outside administrator, even assuming we could have done that at

some savings in expenses, we felt we would be losing one very important characteristic or factor in the Endowment program and that was the board of directors as a group of lawyers with employees responsible to them appealing to the members of the Endowment to support the program. And we thought with our own employees and staff over whom we would have direct supervision we would have a better run, more efficient program, more responsive to the wishes of the participants in the program.

Q. Do you recall what the discrepancy in cost was between the initial James Group proposal and the cost of the Endowment at that time? The costs of running the office?

A. Oh, at that time it might have been 4 to \$500,000 a year.

Q. And your concern with respect to cost was that the James Group might eventually charge you as much as your current costs were?

\* \* \* \* \*

[1478] THE COURT: Good afternoon, please be seated. Are we ready to proceed with the next Plaintiff witness?

MR. GREGORY: Yes, Your Honor, Mr. Ray Zumbrook.

Mr. Zumbrook, if you would go up and stand by the chair, the Judge will administer the oath. Whereupon—

RAY ZUMBROOK

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

MR. GREGORY: Your Honor, I have informed Mr. Zumbrook concerning the procedure we have been following on education and backgrounds and I have asked him to summarize for you his education and military and work experience until the time he became the individual responsible for insurance brokerage services at the ABE in 1962.



THE WITNESS: I graduated from high school in Oak Park, Illinois, in 1944, and proceeded to enroll at the University of Illinois. Upon graduation I put in several semesters before I was drafted at the tail end of world war II. Served in the Army, one [1479] year in the Army of Occupation in Europe, came back and reentered the University of Illinois and finished my undergraduate work in three years and entered law school where I completed a year and a half of law courses and graduated with a BA degree in liberal arts and a substantial number of law credits. I finished off with a semester of insurance courses, and in 1950 took my degree, left the university and started with the insurance brokerage firm of Marsh & McLennan in Chicago. I was employed in their what they called Life Department in the Benefits Section, Employee Benefits Section of the Life Department of Marsh & McLennan in Chicago.

I worked directly for one of the senior account representatives, account executives as they called their sales representatives, and did principally office work and attended meetings with this gentlemen on corporate employee benefit accounts. The largest of these that comes to mind was Beatrice Foods, his principal accounts.

After approximately four and a half years there I left Marsh & McLennan to go with the firm of W. A. Alexander & Company in January, 1955 and I was hired by this firm as the title of Director of Group Sales.

[1480] W. A. Alexander & Company was a general agent representing the Fidelity & Casualty Company of New York for the sale of property and casualty insurance, and housed with W. A. Alexander & Company were approximately 110 commission agents. I was hired by W. A. Alexander to promote the sale of group insurance products with these housed commission agents. Most of them

had some exposure to life insurance and group insurance but technically they were agents selling property and casualty insurance. My job was to train them, to educate them. In doing this, I held seminars with the agents. I did one on one studies with the agents. I took them out to call on their own customers, introducing them and their customers to group insurance products. During the course of my career with W. A. Alexander I was a founder and president of an organization called the Chicago Group Insurance Association, which was the first attempt in Chicago to professionalize people who were involved solely in the sale of group insurance products. Up until that point in time, at least in the Chicago area, the sales representatives of insurance companies were represented by the life insurance agents rather than having their own professional association. We organized this to include the representatives of [1481] insurance companies as well as brokerage representatives as well as consultants.

In the course of my employment with W. A. Alexander, I was called on to teach some business courses at Northwestern University and these were courses in group insurance that were offered to professional people, businessmen, on a night class basis. This went on towards the late 1950's, early 1960's.

At W. A. Alexander in addition to working with the 110 housed commission agents I was also responsible for working with some house accounts where there was no agent as such. The firm was the broker for some larger accounts. One of these was L. Ziegler Corporation, which was the predecessor to Lear Zeigler. Before they moved to Los Angeles I was the brokerage representative on that group account when they first started. I was consultant to one of the brokers in-house on the Bendix account out of South Bend. Again this was in the late 1950's-early 1960s.

In the early fall, approximately August of 1962, I was approached by a Vice-President of Rollins Burdick Hunter Company in Chicago and asked if I would like to join that



company as the manager of their Life Department. The man who called me was the [1482] Vice-President in charge of the Life Department and he was past age 65 and told me he was going to retire in a couple years and I would take his position.

I agreed to that and started work with Rollins Burdick Hunter Company October 15, 1962. At that point in time I assumed managerial duties for a staff that eventually numbered about seven or eight. I assumed duties on major accounts that were office accounts. I assumed some production responsibility for bringing in new business.

#### DIRECT EXAMINATION

BY MR. GREGORY:

Q. Have you resided in Chicago continuously for, oh, the last 32 years or so?

A. Yes, I have.

Q. What is your current address in Chicago?

A. Business address?

Q. Home address.

A. Home address is 648 Hill Avenue, Green Ellen, Illinois.

Q. And your full name is Ray K. Zumbrook?

A. Correct.

\* \* \* \* \*

[1497] MR. GREGORY: The first exhibit, Your Honor, is Exhibit 339.

(The document referred to was marked Defendant's Exhibit No. 339 for identification.)

BY MR. GREGORY:

Q. I have handed you Exhibit 339. Can you identify this document?

A. This is the commission agreement between Mutual of Omaha and James Group Service dated July 1979 and provides three quarters of 1 percent commission on the premium on this particular insurance contract.

Q. This is GMT 8888. That has previously been identified as the disability income program. My question to you is whether you had group insurance commission contracts with respect to the other three Mutual of Omaha programs?

A. Yes, we have, and they are all identical to [1498] this one.

Q. When you say they are identical, do I understand your testimony to be that each contract is identical with Exhibit 339 except for the number of the group policy which is inserted in the contract?

A. That is correct.

Q. And has this contract been in effect since July 18, 1979?

A. Yes.

MR. GREGORY: Your Honor, we offer Exhibit 339 into evidence.

MR. DENNIS: No objection.

THE COURT: It is admitted.

(The document referred to, previously marked Defendant's Exhibit No. 339 for identification, was received into evidence.)

BY MR. GREGORY:

Q. I am now going to show you, Mr. Zumbrook, Exhibit 710.

(The document referred to was marked Defendant's Exhibit No. 710 for identification.)

BY MR. GREGORY:

Q. Can you identify this document?

[1499] A. This document includes several commission agreements between Mutual of Omaha and Rollins Burdick Hunter Company. Also between New York Life Insurance Company, and Rollins Burdick Hunter Company.

Q. The date of your letter to Mr. Breiner is October 2, 1973. Can you state whether these particular agreements were in effect until Rollins Burdick Hunter was terminated as the broker of record for the ABE plan?

A. Yes, they were.

Q. Can you tell us whether in 1976 when the accidental death 250, the ADD-250 program was added by Mutual of Omaha in the Endowment you executed an agreement similar to those contained in Exhibit 710?

A. Yes, that is true.

Q. That was between Mutual of Omaha and Rollins Burdick Hunter?

A. In what year?

Q. 1976.

A. Yes.

MR. GREGORY: Your Honor, we offer Exhibit 710 in evidence.

MR. DENNIS: No objection, Your Honor.

THE COURT: It is admitted.

(The document referred to, previously [1500] marked Defendant's Exhibit No. 710 for identification, was received into evidence.)

MR. GREGORY: We have one more broker's contract. This has been labeled protective information, Your Honor. The gentleman in the audience is an associate in our law firm fully familiar with the protective order requirements. Can you identify Exhibit 340?

(The document referred to was marked Defendant's Exhibit No. 340 for identification.)

THE WITNESS: This is the commission agreement between New York Life Insurance Company and James Group Service.

BY MR. GREGORY:

Q. What is the date of that agreement, do you know?

A. I can't read the date.

Q. I believe it says August 27, 1979.

A. I hope that is a 1979. That is what it should read.

Q. Was this agreement in effect between New York Life and James Group Service from the date it was signed until today?

[1501] A. Yes.

MR. GREGORY: Your Honor, we offer Exhibit 340.

MR. DENNIS: May I see that exhibit, please?

(Document handed to Counsel Dennis by Counsel Gregory)

MR. DENNIS: No objection.

THE COURT: It is admitted.

(The document referred to, previously marked Defendant's Exhibit No. 340 for identification, was received into evidence.)

BY MR. GREGORY:

Q. Mr. Zumbrook, did there come a time in 1979 when James Group Service, Inc., proposed to the Endowment and to Mutual of Omaha that James Group Service, Inc., take over the administration of the American Bar Association's major medical insurance program?

A. Yes, we did.

Q. Can you summarize, please, what the circumstances were that led to the proposal by James Group Service to take over the administration of the major medical program?

\* \* \* \* \*

[1505] Q. Mr. Zumbrook, did there come a time in 1981 when James Group Service made a proposal to the Endowment with regard to the possibility of taking overall administrative functions concerning the insurance program?

A. Yes, we did.

Q. I want to show you a series of documents with regard to that proposal. The first is Exhibit 337, a memorandum dated July 13, 1981, from you, "Subject: ABE administration."

THE COURT: Had you planned to move 729 and 730 into evidence?

MR. GREGORY: Yes, Your Honor. I will be happy to do it now. I would offer Exhibits 729 and 730.

MR. DENNIS: No objection.

THE COURT: They are admitted.

(The documents referred to were marked Defendant's Exhibit Nos. 729 & 730 for identification.)

MR. GREGORY:

Q. Directing your attention to Exhibit 337, Mr. Zumbrook, can you identify the four individuals to whom your memorandum was sent?

A. Yes, Doug Pallay is the President of James [1506] Group Service. Doug Anderson is the Vice-President in charge of sales for James Group Service. Norma Janich is a Senior Vice-President in charge of administration, internal administration, and administration of all of our association business. And Linda Schwartz is Vice-President in charge of our promotion and publication department.

Q. Would you identify the document attached to the cover memorandum on Exhibit 337?

A. This document is the feasibility study we prepared at the request of the American Bar Endowment.

Q. Is this a draft of the study that was ultimately sent?

A. Yes, this is a draft.

MR. GREGORY: Your Honor, we offer 337 in evidence.

MR. DENNIS: No objection.

THE COURT: It is admitted.

(The document referred to, previously marked Defendant's Exhibit No. 337 for identification was received into evidence.)

MR. GREGORY: I am now going to show you Exhibit 329, Mr. Zumbrook.

(The document referred to was marked [1507] Defendant's Exhibit No. 329 for identification.)

BY MR. GREGORY:

Q. Exhibit 329 bears the title "Specifications For Feasibility Study, American Bar Endowment."

My question is whether you can identify the document?

A. I prepared this document for the same four persons previously identified for purposes of making the feasibility study. I formalized the request even though with internal office project I formalized it in the form of specifications, so there would be no question with the staff as to what our purpose was and what we intended to do.

Q. Would you run through this document, "Specifications for Feasibility Study"—if you would excuse me a second.

MR. GREGORY: I would note, Your Honor, that the admissibility of this document is stipulated and I would ask the Court to admit it at this time.

THE COURT: It is admitted.

(The document referred to, previously marked Defendant's Exhibit No. 329 for identification, was received into evidence.)

BY MR. GREGORY:

[1508] Q. Would you start at page 1 and summarize for us what you were attempting to do in putting together these specifications and what type of information is contained in this document?

A. My concern was to distinguish the Endowment program and the Endowment's administration from the typical association plans which these people listed on here were accustomed to seeing and accustomed to administering. So I went to some length to explain that this was not a routine type of administration whereby we would simply go to an insurance company and negotiate a commission and then we would take over the administration. This was to be an arrangement between James Group Service and the American Bar Endowment. And, therefore, there were a number of things we had to consider that we otherwise had not been considering for other association purposes.

So I listed specific items. Things that we had to examine. The budget of the Endowment —



Q. Are you now looking at page 2?

A. I have moved on to page 2.

I gave some history as you may have noted, the Endowment is self-administered, programs for 26 years, so on. These were things the staff really did not know and I am aware of because I had been working [1509] with the program so long and that is what the first page is intended to do.

Beyond that, into page 2 we are looking at certain specific items which had to be reviewed by the people responsible in our office for staff, for accounting, for computer activity and for promotion work. And I touch on each of the various aspects of administration on pages 2, 3 and 4.

Q. Let me ask you to say briefly—just give a quick word of explanation as to each of the Roman numeral categories beginning on page 2, overall budget first, what does that refer to?

A. Well, this is an attempt to emphasize that we are approaching this problem, this report, on a cost accounting basis. I wanted the staff to look at each of the items that we would be servicing, where we would be providing services, where we would be functioning as administrator, examine each of the items in a budget to come up with a cost estimate for the Endowment. I have noted that there are items on the Endowment budget that we would not be responsible for.

Item II, new business promotion, I think the first sentence says the largest single expense item is promotion. This is the biggest part of the budget. [1510] And I asked the lady who runs our promotion department to examine not only what is contained in the specifications here but to examine promotion results from previous years, and I had other copies of booklets and so on that I furnished for her use. That was a specific request requirement on our part to examine the promotion activity.

Page 3, III, billings collections and reports. We would obviously take over all of the accounting procedures. We had to examine our own computer capacity. We examined the arithmetic of the accounting procedures, the procedures performed now by the Endowment, what kind of accounting did they use, what kind of accounting would we use, what kind of reports were they preparing. And included as one of the exhibits is a distribution of premiums by plan, by number of insured people, an attempt to give an itemization of what we would have to do to duplicate the American Bar Endowment processes.

Q. Would you turn to page 4 and summarize the three major categories on that page?

A. Applications and certificates: It is normal in our office to process new applications by simply sending them to the insurance company responsible for the insurance program. The insurance company in turn [1511] would issue the certificate directly to the individual. I was aware that the Endowment did not follow this procedure and I was concerned that we not propose any changes which would disturb the membership of the Endowment should we take over the program. And so we were considering very seriously what would happen if we in effect processed certain applications that did not have to go to the insurance underwriters and if we also issued the certificates.

Claims: The American Bar Endowment pays no claim, they simply act as conduit between the member and insurance company. At James we do do some claim processing. Here again I wanted to distinguish between what we do for other associations and what we were proposing to do on the Endowment business. And that is I decided that we would do what the Endowment did, send the claims to the insurance company, not attempt to process them in-house.

Item VI, customer service and files: We examined some of the services that the Endowment was providing that we did not provide and some of the services the Endowment

was providing that we didn't think had to be provided. And we looked at their filing systems, looked at their word processing, looked at other activities we would have to become [1512] involved with.

Q. And page 5?

A. Page 5, equipment: This is not really my function. I noted that the American Bar Endowment had the latest word in equipment and I assumed that we should provide nothing less than that.

Personnel: This was a statement of concern that if James Group Service took over the administration there would be a number of key people at the Endowment who literally would be out of work. And I think all I was attempting here was to direct the attention of my staff that if we needed to put on additional people here were some well-qualified people we should consider.

Item IX, administrator liaison: I was in fact stating that the relationships between the Endowment board and James would be the same as between the Endowment board and the current Endowment administration; that we would certainly intend to work with all the committees of the Endowment just as the administrative — well, this is the Endowment staff, had always worked.

And then I noted that we needed a final report by August 8, 1981.

Q. Turn to the exhibits, please. There is [1513] Exhibit A, and then the second page Exhibit C, two Exhibits D in this report, and an Exhibit E and F.

Would you tell us what Exhibit A is first, please?

A. A was furnished to me by the Endowment administrator and lists the specific items that went into the Endowment budget for 1981 and the proposed budget for 1982.

I was not concerned about the dollars involved in each of the items, I was only concerned about the items themselves, to make sure that in our analysis of what we

intended to do and in our report back to the Endowment that we had actually looked at each one of these items, so we have not overlooked anything in our presentation.

Q. What does the cross represent in the left hand margin next to certain numbers?

A. The cross indicates certain items of Endowment budgeted expense that we would not assume, such as travel expense for the directors, legal counsel, investment fees would not be part of the James Group Service administration.

Q. Would you explain the next exhibit, please, Exhibit B, overview of ABE programs?

A. That was my own Exhibit for the benefit of [1514] my staff in looking at this project. I put together these number from information furnished to me by the Endowment staff. The premium on the five different insurance plans for this particular period of time, the number of insureds, the number of claims processed by plan, the number of bills prepared by the Endowment accounting department, and the number of new applications processed by the new business department for each of the programs. This was to give us an overview of what we would be expected to do in our own office.

Q. What is Exhibit C?

A. C is a summary of the promotional activity for the 1981-1982 mailing schedule. This was submitted to me by the person in charge of the Endowment Publication and Promotion Department.

Q. And D?

A. There are two Exhibits D. Both of them relate to publications and both relates to the budgeting for publications. And again this was a further explanation of Exhibit C, and it contained dollars of budget for the various campaigns projected for the year. It also contains some editorializing on why the budget was as it was. We were not concerned with that.

[1515] Q. What is Exhibit E?



A. Exhibit E is an analysis of the billings required in order to collect premiums from the members on the various programs. The billings were prepared by the American Bar Association computer system which was leased by the Endowment for this purpose.

Q. And F?

A. I became aware that the American Bar Endowment computer system was producing a lot of reports. I was concerned whether if James Group Service took over the program whether we would need all of these reports. This was a statement prepared by the head of the American Bar Association computer department for Mr. Breiner, in which he lists all of the various reports submitted. Ultimately we determined that we did not need all of these reports if we were going to take over the system.

Q. Ultimately did you submit a proposal to the Endowment?

A. Yes, we did.

Q. Who asked you, what individual at the Endowment had asked you to perform this function?

A. Judge Walter Craig asked me at the June 1981 board meeting, as I recall.

Q. Was he president of the Endowment at that [1516] time?

A. Yes, he was.

Q. I am going to hand you two documents. The first is Exhibit 1718, and the second is Exhibit 737.

(The documents referred to were marked Defendant's Exhibit Nos. 1718 & 737 for identification.)

BY MR. GREGORY:

Q. I would like to ask you to identify both documents, Mr. Zumbrook?

A. Exhibit 1718 is my transmittal letter to Mr. Breiner enclosing the study requested by Judge Craig, with copies of the proposal also given to the directors and Mr. Sutherland.

MR. GREGORY: Your Honor, Exhibit 737 is stipulated admissible. We would also offer Exhibit 1718, the cover letter to Exhibit 737.

MR. DENNIS: Excuse me, you are saying 737? I think once you said 1737, but you are specifically referring to 737?

MR. GREGORY: If I did, I misspoke. The stipulated Exhibit is 737 entitled "Insurance Administration Feasibility Study" and I also offer the cover letter, Exhibit 1718.

THE COURT: All right.

[1517] MR. GREGORY: Both admitted, Your Honor?

THE COURT: Both admitted.

(The documents referred to, previously marked Defendant's Exhibit Nos. 1718 & 737 for identification, were received into evidence.)

BY MR. GREGORY:

Q. Please turn your attention now to Exhibit 737, Mr. Zumbrook. I would like you to do basically what you did before in connection with your specifications and take us through this exhibit, just summarizing what information you were intending to give the Endowment?

A. I would like to note that this is—we did not consider this a proposal to the Endowment; we considered this a feasibility study, which is the reason for the title. This was to give the Endowment an indication of what a third party administrator would charge if a third party administrator was running the insurance plans in lieu of the Endowment staff.

Q. There is a figure in the document as to—on page 6, the figure of \$997,600. Would you explain to me what IV meant, "Proposed Budget for Fiscal 1981-1982"?

[1518] A. This is our estimate of what we would charge the Endowment if we in fact had taken over the administration of the program as a third party administrator. This would be our cost plus our profit.



Q. And how much profit was included in the figure?

A. Approximately 25 percent.

Q. Approximately \$250,000?

A. Pre-tax.

Q. Did James Group Service view this as a competitive bid to the Endowment to take over the administration?

A. Not at the time we presented it.

Q. And why not?

A. I did not want to make an issue of a proposal at this time until I understood what the Endowment had in mind. Basically I was concerned that if we had other competition on this program I wanted to have other options to present a proposal at a later time.

Q. Would James Group Service have accepted an engagement as administrator for the \$997,600 figure on page 6?

A. Yes, indeed.

Q. Let me take you back to page 1. What type [1519] of information is contained on page 1?

A. This is a reminder to the directors of who James Group Service is, a brief statement of our activity in the association business. And it lists our banking facility, our legal counsel and reminds the directors that we are a wholly-owned subsidiary of Fred S. James, the fifth largest of the United States insurance brokers.

Q. What information is contained on page 2, 3 and 4?

A. Page 2, 3 and 4, starting with the heading "Assumptions and Objectives," was my attempt to convince the directors that if we took the program over there would be no changes in the style of management of the program, and no changes in the results of the management of the program.

That is, we would continue to use the same insurance companies, we would continue to provide the same services, and we hoped to wind up with exactly the same dividend result as the Endowment had enjoyed while they

were the administrator of their own programs. And I went to some length to point this out that there would be no changes. On page 2 under item B, dividend maintenance, "the goal of the new administrator must remain the same, increasing funds [1520] for grants and aid through contributions from members and effective cost control."

Pages 2, 3 and 4, I might note at the bottom of page 3, "Money Management," there I make reference to the fact that the Endowment had been earning funds on short-term investments of premiums and that it was our intention to let the Endowment continue doing this. We would simply arrange for the Endowment to handle those funds on a short-term basis.

Q. Did this proposal contemplate James Group Service continuing to receive a commission for services as a licensed broker?

A. Yes, it did.

Q. And would there have been any change in the commission agreements that you previously identified as pertaining to the years in issue?

A. It was not our intent to change those.

Q. Would there have been any compensation to James Group other than the commissions for being a broker and the compensation for the administrative functions set out in this report?

A. No, that would have been the total.

Q. Would you turn to page 3, please.

A. Yes. I have that.

Q. Directing your attention to point one, the [1521] second sentence. I want to ask what you meant by the phrase that two programs were not designed to produce substantial contributions but will contribute to the overall purposes of the Endowment in combination with the other programs?

A. It was a matter of record, a couple years prior to this report that we had been considering taking over both the major medical and the ADD-250 as commercial ac-

counts operated by James Group Service as our own business. I had been—or a comment had been made by one of the directors that there might have been a conflict of interest between James Group Service doing this and also providing consulting advice to the Insurance Committee.

I specified these two programs to indicate that we did not have any intention to spin these off and run them as a commercial business, that they would be considered in combination with the other programs, and that all five programs would continue to be sponsored by the Endowment on an experience rated basis. That is why I named the two.

The rest of the phraseology is "not designed to produce substantial contributions." I guess if I had edited that a little more carefully and said "not designed to produce regular substantial contributions." [1522] I think we noted that we had some problems with the ADD-250 program at the outset. Those problems have cleared up through more favorable claim experience. The reverse has been true of the major medical. Certainly we expected substantial contributions. I know the record shows that. And I think the word "regularly" is missing.

Q. Did you present this proposal at the August 1981 board meeting? Of the Endowment?

A. Yes, I did.

Q. Was the proposal subsequently accepted?

A. No.

Q. I ask you to identify two other exhibits—

THE COURT: Mr. Gregory, I want to take a short break at some point. Is there going to be significantly more direct?

MR. GREGORY: Well, I spilled my water again, if you would not mind taking it now, Your Honor, I would appreciate it. Ten minutes more on direct.

THE COURT: All right.

(A brief recess was taken.)

THE COURT: Mr. Gregory.

MR. GREGORY: Your Honor, during the recess I handed both to the court reporter and to the witness the last three exhibits I have, Nos. 1720, 338, and [1523] 745.

(The documents referred to were marked Defendant's Exhibit Nos. 1720, 338 & 745 for identification.)

BY MR. GREGORY:

Q. Would you please identify Exhibit 1720, Mr. Zumbrook?

A. 1720 is a letter from American Bar Endowment—pardon me—my letter to the American Bar Endowment Director William Falsgraph in which I am responding to his letter concerning certain questions he raised after he received my feasibility study.

Q. Does this letter provide additional information concerning the feasibility study?

A. Yes, it is in response to specific things he inquired.

Q. What is Exhibit 338, it is a letter from you to Mr. Breiner dated October 19, 1981?

A. This letter is in response to certain questions asked of me by Mr. Breiner, and this is my response.

Q. Does this also concern a feasibility study?

A. Yes, it concerns the feasibility study.

Q. The reference at the top of the letter, James Administration Report, does that refer to the [1524] feasibility study?

A. Yes, it does.

Q. Finally, would you identify Exhibit 745, another letter from you to Mr. Breiner?

A. Yes, this one simply is headed administration, but it is the same subject matter. This again is in response to a request from Mr. Breiner for more information regarding the feasibility study.

MR. GREGORY: Your Honor, we offer Exhibits 1720, 338 and 745 into evidence.

MR. DENNIS: No objection.

THE COURT: They are all admitted.

(The documents referred to, previously marked Defendant's Exhibit Nos. 1720, 338 & 745 for identification, was received into evidence.)

BY MR. GREGORY:

Q. Mr. Zumbrook, you have testified you have been involved with group insurance plans other than the Endowment. In your experience have your other group insurance customers sought large dividends on policies?

A. No, to the contrary. I think I should distinguish employer group policy holders who would [1525] definitely not want to receive large dividends. In fact it would be poor money management on their part and on our part if they received large dividends, dividend being simply refund of overpayment on the premium in the first place; it would be negative cash flow for an employer.

As far as association business is concerned, most associations if not all associations I am familiar with are operated as a service for the members and the dividend back of the association simply has to be distributed back to the members which again causes the association a problem.

Q. Why would that cause the association a problem?

A. It indicates they are overcharging the members in the first place and they have to then account for that money and refund it in terms of reducing their rates or giving premium credits on the billing.

Q. Do you view dividends to policy holders and experience credits as compensation to the group policy holder?

A. No, I don't.

MR. GREGORY: I have no further questions on direct, Your Honor.

\* \* \* \* \*

[1531] Q. When you refer to "we" who do you mean?

A. When you say cost, what are you comparing, cost relative to what?

Q. The premium charge.

A. Well, the cost that the person receives in the mail as promotional material doesn't mean anything until he has compared it with something. If he accepts the substance of the organization and the ease of applying he may not even bother to compare it with something.

Q. I think you listed a number of things in your direct testimony concerning what you provide for the American Bar Endowment, what services you provide for American Bar Association: Design of benefits, rating of plans, analyzing reports of insurance carriers, consulting on claim problems, advocating the association's position with the carrier, advising on federal group insurance rules, consulting on promotional activities. Have I left anything out of that list?

A. Not that I can recall.

Q. Would you describe that as being a minimum service arrangement? Is that the minimum services that James Group provides as a broker?

[1532] A. Well, I would like to think that that is a lot more services than anybody else would provide as a broker. But for commission purposes, yes.

Q. Can you describe what a maximum service contract would be?

A. That would be the case where James Group Service would also act as the administrator of the account as well as the broker of record.

Q. What types of services would it perform as administrator?

A. As the administrator we would be involved in the promotion and production of promotion pieces for the direct mailing. He would obviously pay for the cost of the mailing. We would obtain the list for the mailing. We



would process applications for participation in the program. We would bill the insureds at least twice a year for premium. We would act as conduit for claims. And in fact we do pay a lot of claims in our office; we have claim auditors in our office.

We would do those things that are expected of a full service third party administrator.

Q. And other than the payment of claims, the Endowment does all those services?

A. I believe it does.

\* \* \* \* \*

[1603] A. The rates are similar.

Q. The ABE rates are competitive?

A. Competitive with what?

Q. With the non-sponsored plan rates?

A. Generally speaking they are, yes.

Q. You mentioned the substance of the organization as being a factor in determining the attractiveness of a program. Do you recall that?

A. The substance of the organization?

Q. Yes.

A. Yes.

Q. Now, if the rates between the non-sponsor plan and the ABE insurance are comparable would an individual in your opinion be more likely to buy the ABE insurance because of the substance of the organization?

A. Depends on the individual. I would guess normally so, unless the individual does not like the American Bar Association.

Q. But based upon your statement one of the elements of the attractiveness of the program is indeed the substance of the organization?

A. Yes.

\* \* \* \* \*

[1638] A. I think you are dealing with a subject that has to do with the American agency system. This is the way the system works. The broker receives his remuneration from the insurance company. On the other hand, the broker represents his client in the dealings with the carrier. Tradition, is the only explanation I would have for that.

Q. And in this case the group policyholder would determine the range of services performed by the brokerage firm? I think you indicated that you provide minimal services and that you had proposed to provide maximum services?

A. We can either provide a brokerage function for brokerage commission or we can be the administrator of the program and provide all the administrative services.

Q. And the Endowment decides that, what you will provide; is that correct?

A. That is correct.

\* \* \* \* \*

[1653] MR. GREGORY: Your Honor, Plaintiff calls Dr. Dan McGill.

Whereupon,

DAN MCGILL

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

#### DIRECT EXAMINATION

MR. GREGORY: Your Honor, there has been marked as an exhibit in this case Number 336, personal data sheet for Dan M. McGill.

(The document referred to was marked Defendant's Exhibit No. 336 for identification.)

MR. GREGORY: I am going to ask if counsel for the United States has objection to my offer to admit it in evidence at this time?

MR. GREGORY: No objection.

THE COURT: It is admitted.

(The document referred to was admitted into evidence.)

MR. GREGORY: Pursuant to the procedure we followed, I have asked Dr. McGill to summarize his education and professional experience. He made some notes and I would like him to refer to them at this [1654] time and give that summary.

THE WITNESS: I am a graduate of Maryville College, a liberal arts Presbyterian-related school in Tennessee, where I majored in economics. I received my master's degree from Vanderbilt University also with a major in economics. I received my Ph.D. from the University of Pennsylvania majoring in economics with a specialization in risk and insurance. Later I received my CLU, a professional designation awarded by the American College, with reference to proficiency in life insurance.

I have taught at four universities. My first teaching assignment was at the University of Tennessee, where I taught money and banking, corporation finance, and a range of insurance courses. After one year I moved to the University of North Carolina at Chapel Hill, where I held the first endowed professorship of insurance in the country. I was there three years teaching courses in all areas of insurance. I was a Visiting Associate Professor of Insurance at Stanford University in the summer of 1950. I was recalled to military service during the Korean War and upon my release from service I joined the faculty of the Wharton School at the University of Pennsylvania in 1952. I have been at that institution [1655] since that time.

My area of academic specialization at the University of Pennsylvania has been life insurance including group life insurance and pensions. I have been chairman of the Insurance Department since 1965, and have been Executive Director of the S. S. Huebner Foundation for Insurance Education since 1954, serving also as Chairman of the Administrative Board of that organization since 1965.

I am also the founder and Research Director of the Pension Research Council of the Wharton School which has been functioning since 1952. I was president of the American Risk and Insurance Association in 1959, this being the organization of university-based insurance teachers in the United States.

I am the author of eight books, two of which have been awarded the Elizur Wright Prize for being the outstanding book in the field during its year of publication. I am the author of a 1,000 page text on life insurance which for many years was required text for the Society of Actuaries. In that book I devoted two chapters to group life insurance. There was nothing specific in those two chapters about association group life since at the time the second [1656] edition in 1968 this type of insurance had not achieved the prominence that it has obtained today. Until a few years ago I taught group insurance at the University of Pennsylvania either as a part of the basic course in life insurance or as a part of the graduate course entitled Group Insurance and Pensions. For that purpose I have been familiar with all the literature in the group insurance field including group life and group health.

I am a trustee at Northwestern Mutual Life Insurance Company and in that capacity have had an opportunity to observe first hand how rates are made and how dividends are determined and apportioned. Northwestern Mutual does not offer group insurance directly but does offer group insurance for small cases through a fully-owned subsidiary. For six years I was the Director—sorry, I was the Trustee of a New York based company that writes predominantly group insurance and pensions. After having served the maximum term of six years as trustee I became a consultant to the board and continue in that capacity until the present time.

I have also served as consultant to many business and governmental organizations on employee benefit plans. I was consultant to the Board of [1657] Governors of the

Federal Reserve System for 18 years and helped to set up group life and survivor income program with particular responsibility for monitoring the payment of dividends on the case. I have also carried out consultant assignment with the National Education Association involving its association group insurance. Two consulting reports I have prepared have been published as educational materials.

BY MR. GREGORY:

Q. Dr. McGill, what is the focus of study of the American Risk and Insurance Association?

A. That is an organization of professors of insurance in American colleges and universities. It concentrates on the academic and intellectual aspects of insurance.

MR. GREGORY: Your Honor, Plaintiff offers Dr. McGill as an expert in the theory and practice of risk and insurance.

THE COURT: Any objection?

MR. DENNIS: Your Honor, we don't have any objection that he is an expert in the practice of risk and insurance, but as I understand it Dr. McGill is not going to testify concerning the theory of economics.

MR. GREGORY: Dr. McGill is testifying as to [1658] the theory of insurance, Your Honor. Precisely as I stated in my offer. Our offer is on the theory and practice of risk and insurance.

MR. DENNIS: I think we can clarify this on our cross-examination. I have no objection.

THE COURT: Well, a non-objection should be handled expeditiously, so we have time for objections.

Okay, Dr. McGill is so qualified.

BY MR. GREGORY:

Q. Dr. McGill, have I asked you to prepare a list of documents that you have reviewed in connection with your testimony in this case?

A. Did you ask a question?

Q. Yes, did I ask you to prepare that list?

A. Yes, you did ask me to prepare a list.

Q. There is a list. I am going to hand it to counsel for the United States. We had not marked this as an exhibit, Your Honor, it might expedite proceedings if there is no objection if I could seek premission to mark this as an exhibit in this case.

MR. DENNIS: I have no objection.

THE COURT: Fine.

\* \* \* \* \*

[1669] [Dr. McGill] A. And I think perhaps the most important characteristics, or one of the most important characteristics of group insurance is the fact that under the larger cases the net cost of the insurance is determined by the actual experience of that particular group whereas with the individual insurance a policy sold to an individual is treated as a part of a dividend class, and dividends on that insurance, if it is participating, is determined by the experience on that class rather than the experience obviously with respect to one policyholder.

MR. GREGORY: Do you want to break, Your Honor?

THE COURT: I think so, for the reporter, if no one needs a break, but he is working hard.

REPORTER: Thank you, Your Honor.

THE COURT: Let's make it a sharp ten minutes.

(A brief recess was taken.)

THE COURT: Mr. Gregory.

MR. GREGORY: Thank you, Your Honor.

BY MR. GREGORY:

Q. Dr. McGill, prior to the break you were distinguishing individual and group insurance. My [1670] question at this time is whether individual and group insurance are the same insurance products?

A. No, they are different products.



Q. Let me take you back for a moment to the employer-employee situation and your testimony that the employee would receive dividends after the employer's expenses were paid. Is that the case in a situation where the employer pays all of the insurance premiums?

A. No, in that situation the employer receives and retains all of the dividends

Q. Why does the employer retain the dividends in that situation?

A. Because he paid all the premiums in the first instance.

Q. Are you familiar with the term association group insurance?

A. Yes, I am.

Q. What are the essential elements of association group insurance?

A. I would say that the first element is the fact that the insurance program is set up by the members of the association acting through their elected representatives. I would characterize that as controlled by the members of the association. [1671] They will determine the features of the plan in consultation with the insurance company, of course. And to some extent will have something to say about the premium structure.

It is also an arrangement under which the members pay all. That is considered to be an undesirable characteristic in terms of employer-employee plans, in fact it is prohibited under state law in many states, but there is no other party in this case to pay the premiums; it is a mutual undertaking on the part of the members of the association, so the members pay all.

But in view of the fact that when you have that situation that you would have a tendency if everyone was paying the same premium for the younger people either to refuse to join or to drop out. The premium is graded by attained

age, usually by five-year age brackets, or else the amount of insurance is graded downward as the person gets older.

And in view of the fact that the members pay the entire premium it is customary for the members to receive the dividends that are payable under the contract.

Q. You mentioned in your testimony before that association group was a relative newcomer on the [1672] insurance scene. Could you summarize its history, please?

A. It originated in the 1950's, I would say, and it made a considerable amount of sense since one of the key requirements for a sound insurance operation, which I believe I failed to note earlier, is that the insurance should be incidental to the group.

In other words, you should not form a group just for the purpose of getting insurance, otherwise you would not get a fair cross section of the population.

In this case people have a reason for joining the association. It is a common professional bond or interest, and there also tends to be higher income people, better educated. Actually, you should have lower mortality because of the characteristics of the group. So it is the closest thing I would say in terms of saying the basic requirements of a sound insurance operation, the closest thing to an employer-employee group.

But since it did arise after the last major revision of the model group life insurance law and its standard definition in 1946, you do not find the law today dealing with association group, and attempting [1673] to regulate it in the same way that they have done with respect to employer-employee groups, credit groups, and multi employer groups.

Q. Could you summarize for the Court, Dr. McGill, the features of association group that make it similar to employer-employee and the features that make it dissimilar?

A. Well, it is similar to employer-employee group in that it covers a large number of—tends to cover a large number of persons, and it is administered—there is a master policyholder, called the master group policyholder.

The sponsor of the plan always performs a number of administrative services. The sponsor generally promotes the application for the insurance. I would say that in an association group that the sponsor generally performs more services than it would under an employer-employee group.

In the single employer plan the insurance is almost invariably related to compensation of the individual, generally being a multiple of his annual compensation, like two times salary; whereas in association insurance you don't have a salary to tie it to so there will be plans that will provide different specified amounts of insurance, and the [1674] individual members can apply for those, but if they apply for more than the basic amount, which in the case of the Endowment plan is \$20,000, that they would have to execute and submit a health statement.

There may be other differences that I would think of later, but I think those are the principal differences.

Q. In practice who receives the dividend, the policyholder or experience credit in the association group field?

A. Almost invariably the members of the association receive the dividends or at least they are credited against their next year premiums.

Q. Is that result consistent with insurance theory?

A. It is absolutely consistent with insurance theory and with the contribution concept of dividend distribution.

Q. Under insurance theory is there any other group, organization or person who might have a claim against the dividend or experience credit?

A. No, there is no other organization that would have a proper claim in my opinion.

Q. Dr. McGill, if you would focus, continue your focus on association group insurance: What [1675] factors produce a result in an association group plan where there indeed are dividends or experience credits to be paid?

A. The dividends under any group insurance plan are the difference between the gross premiums paid plus any investment earnings that might be credited to various reserves that are accumulated under group plans, less the incurred claims, less the retention of the insurance company, and that is the dividend.

Now, naturally, anything that affects the mortality or morbidity of the group will have an impact on the dividend, and also the efficiency with which the plan is administered and the size of the commission that is paid and the premium tax that might be involved. So the more favorable the mortality and morbidity and the lower the expenses, the greater will be the dividend.

Q. You mentioned the phrase mortality-morbidity experience. How is that derived?

A. Do you mean in the first instance what assumption is made or how does it occur?

Q. What do you mean when you use those terms?

A. Mortality has reference to the death rate, whereas morbidity has reference to the sickness or disability rate in this context. And, obviously, in [1676] setting the initial scale of premiums the insurance company is guided by either mortality or morbidity tables that reflect observed experience of similar groups; but in a large case the actual experience is determined by the characteristics of the individuals in the plan.

Q. Let me direct your attention to the Endowment plan. Whose characteristics determine mortality and morbidity results in that plan?



A. The precise characteristics of the persons who participate in the plan. I understand they are all attorneys and members of the American Bar Endowment, so it would be the particular characteristics of that group that would determine the experience of the plan and indirectly the dividends that would become available.

Q. Would you expect in practice that a professional association might have the same, better, or worse experience in morbidity and mortality than the population as a whole?

A. In my expectations and in theory, this group should have better mortality and morbidity experience than the general population because they are a higher-income group, presumably somewhat more intelligent, they have access to better medical care, [1677] take and utilize more medical care and have better nutrition and presumably are just more sober individuals generally than the population.

And in this case, experience has demonstrated that the theory is correct. In fact, the mortality and morbidity experience on association group insurance is better than that of the general population.

Q. What is a group policyholder, Dr. McGill?

A. Group policyholder is a party to the insurance contract with the insurance company and is the organization to which the master group contract is issued.

Q. What role is performed by an association group policyholder in the overall plan of insurance?

A. The policyholder performs an important administrative service, including the promotion of the insurance; and it also acts in a way to protect the interest of the plan participants.

Q. In what way does the group policyholder act to protect the interest of the plan participants?

A. Well, one, there are, of course, a number of provisions in a group insurance contract; there are even a number of so-called standard provisions that are required

by state law that are designed to protect [1678] the interest of the policyholder. One being the conversion privilege, for example, the group policyholder will make sure that those provisions are observed by the insurance company. They, of course, collect the premiums, remit the premiums, maintain the basic records, and certify the entitlement to benefits of people who die or become disabled or have medical expenses that become payable. So the group policyholder would represent the participants in any dealings with the insurance company, and of course would in the absence of an assignment of dividends would make sure that the dividends are made available to the participants in the plan.

Q. In insurance theory and practice does the association group policyholder stand in an agency relationship with the insured members?

A. In my opinion the master group policyholder in the association case is acting in an agency capacity.

Q. In insurance theory and practice does the master group policyholder in an agency case stand in a fiduciary relationship with its members?

A. I feel that that relationship could well be construed as being fiduciary in nature.

Q. In fulfilling its role as group policyholder [1679] as a matter of insurance theory and practice should the association make a profit on the association group insurance at the expense of the insured member?

A. Absolutely not.

Q. Dr. McGill, how does one compute the cost of an association group insurance plan?

A. You could express it two ways. You can say it is a gross premiums less incurred claims less retention, plus allocable expenses, which of course gives you the dividend. So it is really the gross premiums less the dividends plus allocable expenses would be one way.



But the other way to look at it is simply it is incurred claims, the expenses of the insurance company and the expenses of the master group policyholder. Those three elements would constitute the cost of the insurance in the broad sense.

Q. What is your definition of fair market value?

A. I think fair market value is the price at which a good or service would be exchanged between a willing seller and a willing buyer, with neither being under compulsion to buy or sell and with each having knowledge of the relevant facts concerning the transaction.

Q. How should an individual go about [1680] determining the fair market value of an insurance product?

A. I think you determine the fair market value of a given insurance product in terms of the net cost to the policyholder. And in individual insurance the net cost is the gross premium less the dividend, if it is a participating policy.

If it is non-participating, it is the gross premium that has been paid. In association and any group insurance case the net cost is the gross premium less the dividends and that would be true also of an association group case.

Q. Dr. McGill, in your opinion would the net cost of insurance in an association group case change if the members of an association permitted the association to keep dividends or experience credits for charitable purposes?

A. No, sir, that has nothing to do with the net cost. That simply has reference to the disposition of the premium refund.

Q. In valuing an insurance product, Dr. McGill, is it proper to value that product by reference to the characteristics or value of a different product?

A. In my opinion that would be absolutely unjustified to value a product in terms of the costs of [1681] some other product.

Q. May the fair market value of a particular association group insurance plan be tested by reference to the price of some other type of insurance?

A. No, sir. That would be improper.

Q. May the fair market value of a particular association group insurance plan be tested by reference to a different group and the characteristics of the different group?

A. Absolutely not.

Q. May the fair market value of a particular association group insurance plan be tested by reference to individual insurance?

A. No, that would be a different risk classification all together.

Q. May the fair market value of a particular association group insurance plan be tested by reference to the price of mass marketed commercial insurance issued by a credit card company?

A. No, that would be grossly improper.

Q. What about an oil company?

A. Same answer, it would be improper.

Q. What about a bank?

A. No, you would not use the Washington Bank as your frame of reference.

[1682] Q. When looking at the fair market value of a particular association group insurance plan what must that value be tested against?

A. Against the experience of that particular plan and that product.

Q. Would you define mass marketed commercial insurance?

A. That does not have a statutory definition, but it is generally used to refer to insurance offered to persons who hold credit cards with a particular organization like American Express, or hold gasoline credit cards with Shell

Oil or some oil company; or insurance issued on the lives of people who are joined together in some very loose bond of that sort.

Q. Is mass marketed commercial insurance considered to be group insurance?

A. Well, there is a question about that. Some people would regard it to be. In some states it is probably authorized and would be regarded as group insurance. In other states it would not be permitted.

And even where it is permitted there have been many questions raised as to whether it really is a form of individual insurance being marketed under a franchise arrangement.

Q. What is a franchise arrangement?

[1683] A. Well, it would be a type—generally the term franchise insurance is used to apply to a group that falls somewhere inbetween a case that would qualify for true group insurance and individual insurance.

Generally it represents the situation in which individual policies are issued to the people rather than just certificates that you get under a group case. There is generally a larger commission paid to the servicing agent or broker. And there will not be the economies of scale involved in franchise insurance that you have with a true group case.

Q. I would like to direct your attention now to mass marketed commercial insurance on the one hand and to association group insurance on the other, and ask you a question similar to questions you have answered before.

Would you explain to me what features make mass marketed credit card insurance similar to association group and what features make it different?

A. A mass marketed plan, if it is truly issued on a group basis, and with certificates instead of insurance, and with all the economies that you associate with group insurance and with the other safeguards that you associate with group insurance, I [1684] think would be comparable

to association group except for the motivation. The motivation behind mass marketing is profit. Profit to the insurance company and profit to the sponsor of the plan.

Whereas in association group you generally—the insurance is offered as a service to the membership, and made available by representatives of the association with the plan being designed for the particular needs and aspirations of the members, whereas a mass marketing scheme is likely to be taken off the shelf and just contain fairly standard features and is operated for the benefit of the sponsors and the insurance company.

Q. Do commercial mass marketers of insurance make an entrepreneurial profit for their endeavors?

A. They attempt to. They may or may not.

Q. Dr. McGill, as a matter of insurance theory and practice, is it appropriate for an association group policyholder to make an entrepreneurial profit?

A. No, it is not appropriate.

Q. In commercial mass marketing insurance does the insured consumer have any control over the management of the company that mass markets the insurance?

A. No, the members have—the insured members [1685] have no control over either the insurance company or the organization that sponsored the insurance.

Q. And in commercial mass marketing insurance does the insured consumer have any control over the insurance program, terms, conditions, et cetera?

A. No, sir.

Q. In the association group field does an association member have control over the organization that sponsors the insurance?

A. Yes, the members control the association, and through their representatives determine the features of the plan.



Q. Is an offer by a third party administrator to administer a group insurance program an appropriate basis for determining the fair market value of the administrative services performed by the association group policyholder?

A. I think it is not only an appropriate basis, but the best basis, perhaps the only basis.

Q. Dr. McGill, if commissions are agreed upon between an association group policyholder and a third party broker, is that an appropriate way of valuing the services of the broker?

A. I would say it is.

Q. Dr. McGill, if a list is distributed [1686] commercially, and I mean a list of names for mass marketing purposes at a certain price to all who ask for it, is that an appropriate way of valuing the list?

A. It seems to me that is highly appropriate.

Q. Dr. McGill, did you make any rate comparisons between the American Bar Endowment plan and other insurance plans in preparation for your testimony today?

A. I did not make any systematic comparisons.

Q. Why did you not make rate comparisons systematically?

A. I felt that the issue was irrelevant to the present case.

Q. Why is the issue irrelevant in your opinion?

A. Because we know what the net cost of insurance is in this case. It is the gross premiums less the dividends plus the allocable expenses. So what the cost of some other plan would be is completely irrelevant to this case.

Q. Dr. McGill, as a matter of insurance theory and practice, do the insured members of the American Bar Association represented in this case have a right to the dividends and experience credits which they could assign to the Endowment for charitable purposes?

A. Under established practice and concepts and [1687] under the contribution theory of surface distribution the plan members would be entitled to the dividends.

Q. Dr. McGill, have you relied on any documents forwarded to you by my law firm to reach your conclusions in this case as expressed in your testimony?

A. I obviously have relied upon the documents in attempting to get a grasp of the factual situation and the issues involved, but the materials that I have read and the briefs filed and the opinions of the lawyers expressed have had no impact on the conclusions that I reach with respect to the case.

Q. As a matter of insurance theory and practice, Dr. McGill, is the American Bar Association in the business of insurance?

A. No, sir, it is not in the business of insurance.

Q. Does the American Bar Association bear an insurance risk?

A. It does not bear any insurance risk.

Q. Does the phrase "wholesale price" mean anything to you in terms of insurance theory and practice?

A. I have never heard it used.

Q. Does the phrase "retail price" mean anything [1688] to you in terms of insurance theory and practice?

A. Not in this context.

Q. Dr. McGill, have you ever heard a group policyholder of any kind described as a "middle man"?

A. Not by any informed person.

Q. Dr. McGill, have you reviewed the materials we forwarded to you concerning the disclosure by the American Bar Endowment to its members about the charitable nature of the insurance program?

A. Yes, sir, I have reviewed those materials.

Q. In terms of your experiences, did you find those disclosures usual or unusual?

A. I find them to be very unusual because it is very unusual for the dividends to be assigned to the sponsoring organization and therefore that would not be the need for such disclosure as we find in this case.



Q. Dr. McGill, have we compensated you for your expert assistance in this case?

A. Yes, sir, you have.

Q. And did we do so on an hourly rate basis?

A. Yes, sir.

Q. What rate per hour did you ask us to reimburse you at?

A. My standard rate, which is \$125 per hour.

[1689] MR. GREGORY: May I have one moment, Your Honor?

THE COURT: Of course.

MR. GREGORY: No further questions on direct, Your Honor.

THE COURT: Thank You.

Mr. Rubloff, I see you are no longer handing questions up, you are actually going to get to the witness.

MR. RUBLOFF: Seems Mr. Dennis is all tuckered out, so he asked me to pinch hit.

THE COURT: After last Friday night, when he went carousing on the town and left us all here to handle the questions?

#### CROSS-EXAMINATION

BY MR. RUBLOFF:

Q. Dr, McGill, it is a pleasure to make your acquaintance.

Unfortunately, Doctor, I didn't have the opportunity to take your deposition and I am not as conversant with your thesis as I would like to be. But I have looked through the transcript and I listened to your examination this morning.

\* \* \* \* \*

[1693] A. But generally speaking, you have to have a defined group, a class of person that could be objectively defined and then offer the insurance to that group. So I would make, you know, allowances for the fact that you may have a pretty loosely formed group; I would say that

with the association group you have very clearly defined limits because of the affiliation with the professional organization like the American Bar Endowment.

Q. Well, I am not sure of your answer. Do you know of any particular law or regulation which would have prohibited the American Bar Association from entering into a legal arrangement with an insurance company under which it would sell insurance to both members and nonmembers?

A. First of all, I repeat that quote the American Bar Association does not sell insurance. And I don't believe that it would be permissible. There is a requirement that organizations that assume insurance-type risk must be legally licensed insurance companies. And the question who is doing the insurance business has been around for many many years, [1694] and if an organization is making insurance available on a vocational basis, which I would so interpret your hypothetical situation, it would be forbidden under state law, I think in most all states, from acting in that manner unless it is willing to make itself subject to all the regulations, laws and regulations pertaining to insurance companies.

Q. Well, turning that around then, are you saying that it is legally permissible for an association to sell to professionals in general, that it doesn't have to necessarily sell just to their members?

A. No, I am saying that a professional association must confine its insurance offering, if we may characterize it in that manner, to its membership. That is my understanding.

Q. Of what, the law?

A. It is my understanding of the law and practice.

Q. Well, we won't belabor that subject.

A. Yes.

Q. Let's assume that you are mistaken.

A. Assume that I am mistaken?

Q. Yes.

A. Okay.

[1695] Q. And that indeed the ABE or any organization like it could sell to nonmembers.

A. Yes?

Q. Would that fact change your opinions and conclusions?

A. Well, you would have to define in much more detail what the arrangements are. If you are saying the American Bar Association has recast itself into forming an insurance company, subject to all respects to regulation by the appropriate insurance commissioner, and they go out to offer insurance to the general public, that would depend on the terms of the arrangement. They may be offering non-participating insurance. So you would have to define in much more specificity what the arrangement would be.

Q. I didn't mean to suggest anything such as you have just decribed. I meant to suggest that if all the facts were as they are with the one exception that the Endowment was soliciting and accepting coverage from nonmembers, would that in any way change your conclusions and opinion?

A. Well, it has been so long since I stated my conclusions and opinions, I believe you need to restate which specific conclusion that you have in [1696] mind.

Q. The ultimate conclusion which we started with, and that is that the fair market value of the insurance is always its net cost?

A. Yes?

Q. Now, would that be true even if the insurance was sold to nonmembers?

A. To those nonmembers, yes, the net cost of insurance to them would be the difference between the gross premiums that they paid and the dividends that were generated under the plan. That would be their net cost.

Q. The reason I ask you that is I am trying to get to ascertain the relationship between the fact that this is a group association and your testimony that in your judg-

ment the asociation had some sort of fiduciary obligation to its members. Was that fiduciary obligation a very important element of your analysis?

A. No, I would come to the same conclusion if it were not a fiduciary. I think it is possible it is only an agent rather than fiduciary. In laymen's terms I think it is acting on behalf of the members and you can characterize it as an agency relationship versus fiduciary relationship. But I do not believe [1697] that the Endowment has any legal claim to the premium refunds that come into the monies that constitute a refund of the premiums paid by the members in the absence of a specific agreement to the contrary.

Q. And what I am getting at is is that because of the relationship of the association to its members or is it because of some other fact?

A. No, it is because of the whole arrangement. The fact that this is a group of professionals with a common interest in their profession represented in the development of the plan and in its operation by their own elected representatives, and I think those elected representatives have the obligation, which can be described as a fiduciary obligation, to operate the plan in the interest of the members, and to make the premium refunds available to the members, except for this fact, in this particular case, that the dividends have been previously assigned to the Endowment as a condition of participation in the plan.

Q. Now, in your view would the association have the same obligation to nonmembers, in my hypothetical?

A. I think any group policyholder has an obligation to administer the plan on behalf of all the members of the plan, and to protect the rights and interests of the participants. I am sure that as a [1698] practical matter they wouldn't feel the same affinity, community of interest, with just a general member of the public as they would with one of their own.



Q. Now, given what you have just said, does that mean then that it is not important to your analysis that the insured happen to be members of this association? What is critical to your analysis is that the association is the group policyholder and whoever happens to be the insured it has some obligation to?

A. Well, I think that if there was to be any difference whatsoever, we are saying that you have got the group of professional people who have organized their own mutual undertaking set up through their own representatives.

In a sense there is no assumption of any risk by that group, it is transferred to the insurance company. Once you introduce an extraneous circumstance and someone is not a member of that association, you might argue that the Endowment, even though it is not an insurer, it is bringing people into the picture for whom they would have no other obligation, and the fact that they are now a member of the plan. But I think I go back to the answer that the key factor here is the fact that it is a group of [1699] people who have set up a plan for their own benefit and with the plan being administered for their benefit by their own elected representatives. Administered for their benefit by their own elected representatives.

Q. Dr. McGill, is it relevant to your thesis that the ABE was a charity?

A. No. The net cost of insurance would be precisely as I defined it even though this was a commercial undertaking.

Q. Well, am I correct that you would characterize the reversion back of the dividend from the insured to the association as a gift?

A. It is a charitable contribution, yes.

Q. Or a gift, same thing, right?

A. Yes.

Q. And would you regard the same mechanism as resulting in a gift if the ABE happened to be something other than a charity?

A. It would be a gift but it would not be a charitable gift, wouldn't be deductible.

Q. But a gift?

A. It would be a gift if they assign their dividend to the Endowment, yes.

\* \* \* \* \*

[1708] A. I want to make it perfectly clear, as has been said by other people, that what we are talking about in this case is the American Bar Endowment acting as an intermediary offering on behalf of New York Life and Mutual of Omaha the types of insurance coverage which the Endowment actively promotes in order to generate charitable income for charitable purposes. I don't think that the Endowment feels that it is in competition with every organization out there offering insurance, because absent the charitable motive it is not very attractive insurance. They are paying a fairly high gross premium generating dividends of roughly 50 percent, and it would not be very attractive in the absence of the charitable impulse of the members. But in the very broad sense that any insurance is in competition with every other similar type of insurance, I would say that this program has some competition but I think that the Endowment has the very specific charitable motive and offers insurance for this purpose, and obviously aggressively promotes it among its members in order to maximize the charitable income that it will have in [1709] order to carry out its very laudable purposes.

Q. Well, just to clarify what you said: I understood from your direct testimony that you were not professing to be an expert on the relative price of the ABE's insurance as compared to competing insurance?

A. I didn't say that I am not an expert, I said I considered it irrelevant and did not investigate it.

Q. Right. Well, but are you nonetheless aware of the market rates?



A. I am generally aware of market rates, yes.

Q. And is that awareness and knowledge the basis for your comment a moment ago that the ABE's gross premiums were relatively high?

A. In comparison to some other cases of other premiums. But I would say that my conclusion was primarily based on the fact that I know from the dividend history that there has been almost 100 percent overcharge, and that would lead me alone to feel that unless we have very imperfect competition, that the rates must be in the higher range that are being charged.

Q. Is that a deduction that you arrive at or is it based upon your knowledge of actual prevailing rates?

[1710] A. No, the prevailing rates has nothing to do with it. I am saying that the rates that have been set for the life insurance portion of this ABE program have rather consistently generated dividends around 45 to 50 percent, so I am saying that any logical person, I mean any person could logically conclude that he or she is being overcharged for the insurance for a very specific purpose, to generate dividends. So I am saying that you couldn't expect an organization that sets its rates or persuades the insurance company to set its rates at a level to generate dividends of that scope, that you would find it hard to believe that any other organization that is charging those gross premiums and hoping to attract its share of the market would be much higher than this. I would think that generally it would be lower.

Q. Well, to use the vernacular, are you saying there is so much water in the gross premium rates of the ABE that they must be higher than other rates that don't have the water in it?

A. I would never use that term.

Q. I did.

A. In insurance I would never use that term. I am saying that margins were built into the gross premium structure with the deliberate intent that [1711] there be

premium refunds which would then go to the Endowment under the arrangement entered into by these members. And I am saying that the margins were such that you would normally expect any organization that was trying to compete on the purely commercial basis, that their rates would be lower and not — at least not much higher than the ABE rates.

Q. But this is surmise on your part, you don't know it as fact?

A. I don't know it, and I don't care. I think it is irrelevant.

Q. Again I am using the word, I won't attribute it to you, but wouldn't you expect to find water in some other group policies?

A. I would expect to find water, if you want to characterize it that way, in some of these commercial mass marketed schemes and I might even say water or something worse in those cases.

Q. So in that respect they would be very similar to the ABE's program?

A. They could be. No, let's not say similar. I would say the rate structure, the gross premiums could be similar to the gross premiums being charged by the ABE, but I have no personal knowledge of that.

Q. Or is it quite possible the ABE rates are [1712] actually lower?

A. It is possible.

Q. And they compete with one another?

A. Only in the sense that I conceded earlier.

Q. Right. Now, am I correct that in your view the principal difference between the so-called mass marketed commercial insurance programs and the ABE program is motivation?

A. That is what I said, and I believe that.

Q. And you were referring to the motivation of the marketer?

A. I was referring to the motivation of the sponsor of the arrangement.

Q. Does the word marketer —

A. It is a loaded word, I do not use the word marketer.

Q. Well, I don't mean to use a loaded word. What is wrong with that word?

A. I would rather use the term master policyholder, master group policyholder or sponsor of the arrangements.

Q. I am sincerely interested. What is wrong with the term marketer, is it a misdesignation?

A. I do not concede that making insurance available from the insurance company to a given class [1713] of people by an intermediary constitutes marketing the insurance. I think that is a question of interpretation.

Q. We won't get into that one, we have a limited amount of time.

A. Yes.

Q. Motivation: The motivation of the mass marketer of commercial insurance—if that is the right term—he wants to make the profit, right?

A. Yes.

Q. And the motivation of ABE?

A. Is to generate premium refunds that would come to the Endowment and support its charitable purposes. With full knowledge now. I think I need to make this clear. A very important aspect of this is that the members of the Endowment sign the agreement knowing that they will assign these dividends. Every year they get a notice, as you well know, that tells them the percentage of their gross payment that constitutes the charitable deduction. There is full disclosure at all times. Whereas with the commercial arrangement there is the same desire to have a margin in the gross premiums but for different motives. And also we believe, if we can believe the discussions we see within the NAIC Task Force, there has been [1714] inadequate

disclosure or perhaps no disclosure to the participating members as to the fact that they are paying perhaps a grossly excessive premium.

Q. Can we agree that the real distinction as to motivation of the group policyholder is not really the question of profits but rather a question of what is going to be done with their profit?

A. No, I would not agree with that.

Q. Would you argue with the notion that the ABE is trying to make a profit so that it can use those profits for charitable purposes?

A. Look, I know that the use to which monies are paid has no bearing in this legal issue involved in this case. I am trying to stick to the very basic. And I don't think that the fact that the ABE is going to use the money for charitable purposes, as laudable as it is from the social standpoint, has anything to do with the legal issues involved in the case.

I do think that the fact that there is full disclosure and that the members know that they are going to forgo the dividends and that they are told each year they have forgone the dividends and exactly how much, that puts this case in a completely different category from the commercial cases.

\* \* \* \* \*

[1732] Q. Well, do you recognize the possibility that the people in the Endowment who are setting the rate structure have one purpose, and the people who are buying the insurance have another?

A. I regard the officers of the Endowment to be acting on behalf of the plan members who are kept fully informed of what is going on. They are informed in advance, informed annually. There is a great deal of communication, at each annual meeting there is discussion of this, and I feel that if the members as a group do not like



what their representatives are ~~doing~~ that they can cast them out and certainly withdraw from the program. I do believe in a very real sense that the officers of the Endowment are acting on behalf of the plan members and attempting to carry out their desires and wishes.

Q. Are you saying that you really believe that the attitude about the rate structure as between the people who are establishing the rates and the people who are paying the rates are parallel?

A. Not parallel in that every member of the [1733] plan if given the opportunity would set the rate exactly where it is. But I am saying that the members of the plan as a group realize that they are joining in a program that has a dual purpose. One is to provide valuable insurance coverage to themselves at a rate that will generate a payment to the Endowment as a charitable contribution. And naturally where that rate is set is a matter of judgment. The officers of the Endowment have to judge the strength of the charitable impulses of the membership, but once they have set it and a certain percentage of the members of the Endowment elect to take the insurance, I think they are acting in a fully informed manner, and are certainly accepting that rate structure as long as they participate in the plan.

Q. But from a practical standpoint, isn't it true that an individual member when he is offered this insurance really has two choices: He can either buy the insurance or not buy it?

A. That is right.

Q. But he can't change the rates?

A. He can not change it any particular year. He accepts it at the rates quoted, or he buys elsewhere.

\* \* \* \* \*

[1747] MS. CARPENTER: Your Honor, our next witness is Ms. Emily Ryerson.

THE COURT: Good afternoon, Ms. Ryerson.  
Whereupon—

EMILY RYERSON

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

THE COURT: Sorry that you had to wait around all day. We hoped to get to you earlier. Hopefully you will be done this afternoon. You live in Chicago?

[1748] THE WITNESS: Yes, I do.

THE COURT: You may be on your flight this afternoon.

MS. CARPENTER: We promised to take Ms. Ryerson to dinner in order to make up for her delayed testimony.

THE COURT: Hold out for a nice place. We have some excellent restaurants in Washington and I am sure Sutherland, Asbill & Brennen, their law firm, Plaintiffs, is well acquainted with them. I won't endorse one in particular, but they know.

DIRECT EXAMINATION

BY MS. CARPENTER:

Q. For the record would you state your name and home address?

A. Emily Ryerson, 2006 South Loomis, Chicago, Illinois, 60608.

Q. By whom are you employed?

A. The American Bar Association.

Q. And what is your position with the ABA?

A. List manager?

Q. What does a list manger do?

A. We maintain and rent the American Bar Association membership list.

Q. How did you come to obtain that position and [1749] how long have you been there?

A. I have been there about five and a half years and I was obtained when the list management program started.

Q. You mean when the ABA first started to rent its list?



A. That is correct.

Q. And how long have you been in direct mail?

A. Since 1951.

Q. You have in front of you what has been marked as Exhibit 1212.

(The document referred to was marked Defendant's Exhibit No. 1212 for identification.)

MS. CARPENTER: Your honor, I put a copy on your desk.

BY MS. CARPENTER:

Q. Can you identify this document?

A. Terms and conditions. It is for use of our membership list.

Q. Is this the contract that all the customers for your list must sign?

A. Yes.

Q. Has this been in use since the list rental program started?

[1750] A. Correct.

Q. Who owns the ABA membership list?

A. The ABA.

Q. Do you sell it?

A. We rent it.

MS. CARPENTER: We offer 1212 in evidence.

MR. MARKHAM: No objection, Your Honor.

THE COURT: No objection. It is admitted.

(The document referred to was received into evidence.)

BY MS. CARPENTER:

Q. Ms. Ryerson, next I am going to show you what has been marked as Exhibit 1209. I think you saw this document in your desposition as well.

(The document referred to was marked Defendant's Exhibit No. 1209 for identification.)

BY MS. CARPENTER:

Q. I ask you if you can identify that document?

A. Yes, it was the original promotion mailing that went out when the membership decided to start renting their list.

Q. And does this document indicate that the ABA membership list is available to insurance companies?

A. Yes.

[1751] Q. And where is that indicated?

A. It is indicated on "Lawyers, their prime prospects for your company's product and services."

Q. And the word life insurance is listed under that heading?

A. Yes, it is.

Q. To your knowledge has the ABA membership list always been available to insurance companies and brokers since the rental program was initiated?

A. As far as I am aware, yes.

Q. And have you always been the list manager?

A. That is correct.

Q. And did the customers come through you?

A. Yes.

Q. And are you the person charged with responsibility of soliciting customers for the ABA list?

A. Correct.

Q. Now, what is the price of the list at this time? When did this brochure go out?

A. In 1978.

Q. 1978?

A. Yes.

Q. And what was the price of the list at that time?

[1752] A. The base price was \$35 a thousand.

Q. Suppose someone had wanted to rent the whole list, wanted to send a promotional piece to every ABA member at that price. What would that cost?

A. Approximately \$7,000.

Q. Suppose I wanted to split the list? Suppose I were an insurance company that only wanted to contact members who were age 30 to 50. What would be the price for that kind of list?

A. An additional \$2 per thousand.

Q. So it would cost you \$37 for a thousand names?

A. Correct.

MS. CARPENTER: Your Honor, we offer Exhibit 1209.

MR. MARKHAM: No objection, Your Honor.

THE COURT: It is admitted.

(The document referred to was received into evidence.)

BY MS. CARPENTER:

Q. Next I am going to show you what has been marked as Exhibit 1210, a document that was also used in your deposition, and ask you if you can identify that?

A. It was our promotional mailing piece in 1980.

[1753] Q. Did you say in 1980?

A. Yes.

Q. And what was the price of the list at that time?

A. It was \$35 per thousand.

Q. So you had not raised your per thousand?

A. Not at that time.

Q. But did the total list cost more at that time?

A. Yes, because we had additional members.

Q. Now, in July of 1980 what would be the approximate cost of sending a piece to all members of the ABA?

A. Approximately—about \$8700.

Q. Was the splitting by date of birth still available?

A. Correct.

Q. So that it would still cost you \$37 for a thousand names if you wanted to split an age group off?

A. Correct.

MS. CARPENTER: Your Honor, we offer Exhibit 1210.

MR. MARKHAM: No objection, Your Honor.

(The document referred to was received into evidence.)

[1754] MS. CARPENTER:

Q. Has the ABA raised its prices from \$35 a thousand?

A. Yes.

Q. When did that take place?

A. In 1981.

Q. What is the current price?

A. \$40 a thousand.

Q. What does it cost today approximately to rent the entire membership list?

A. A little better than \$10,000.

Q. Does the American Bar Endowment rent its list from your list department?

A. No.

Q. I am going to show you what has been marked as Exhibit 270 and ask you if you can identify it?

(The document referred to was marked Defendant's Exhibit No. 270 for identification.)

A. It is my fiscal 1979-1980 sales report.

Q. What information is contained in your fiscal year 1979-1980 sales report?

A. Total numbers of orders. Number of labels. The net amount of money received. And commissions paid.

[1755] Q. Just by way of example, would you pick one of the pages and just indicate to us how to read this particular sales report? I think—let's see, on the eighth page, the Connecticut mutual life insurance company appears toward the bottom of the page.

A. They had two orders, total amount of labels 3,104.

Q. Would that mean they rented 3,104 names?

A. Total for the two orders. And it cost them \$35.

Q. And would the other information on here be read in the same fashion?

A. Correct.

MS. CARPENTER: Your Honor, we offer Exhibit 270.

MR. MARKHAM: No objection, Your Honor.

THE COURT: It is admitted.

(The document referred to was received into evidence.)

BY MS. CARPENTER:

Q. Finally I am going to show you what has been marked as Exhibit 272 and what has been marked as Exhibit 350 and ask you if you can identify these two documents.

(The documents referred to were marked [1756] Defendant's Exhibits No. 272 and 350 for identification.)

THE WITNESS: These are my job instructions.

BY MS. CARPENTER:

Q. Can you describe what is reflected in Exhibit 272? What is it?

A. 272 is InterAmerica Life Spring of 1981 rented names through the direct media brokerage. They wanted members of certain sectional centers for the year of birth 1930 on under.

Q. So they were looking for older members?

A. That is correct.

Q. And how many names did you supply them and what did you charge them?

A. 4,692 names; and it cost them \$215.

Q. And is the promotional piece that was sent to these 4,692 members of the ABA attached to your job instructions?

A. Correct. Not to my job instructions, the final into my file.

Q. And that is the advertisement for prime life-50 plus?

A. That is correct.

Q. And can you identify Exhibit 350?

A. It is also a job instruction, from Western [1757] New England group insurance. They ordered 10,000 names from various dates and they wanted young lawyers under the age of 45 years old.

Q. What did you charge them for 10,000 names?

A. \$454.

Q. I want to direct your attention to the years in issue, which are July 1, 1978, to June 30, 1981. Were you willing during those years to make the ABA membership list available to responsible insurance companies?

A. I would see no reason why we shouldn't have.

MS. CARPENTER: Your Honor, we offer Exhibit 272 and Exhibit 350.

MR. MARKHAM: No objection, Your Honor.

THE COURT: They are admitted.

(The documents referred to were received into evidence.)

#### CROSS-EXAMINATION

BY MR. MARKHAM:

Q. Mrs. Ryerson, can you estimate the number of insurance companies that have rented all or part of the list since you have been employed as the list manager?

A. Not right off, sir, no.

\* \* \* \* \*

[1787] MR. GREGORY: Next and last is the gentleman patiently waiting here, Your Honor. It is Mr. Lindsay. Whereupon—

ROBERT LESTER LINDSAY

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

#### DIRECT EXAMINATION

BY MR. GREGORY:

Q. Mr. Lindsay, would you state your full name and your home address and your present employer?

A. Robert Lester Lindsay, 2 Huguenot Court, Tenafly, New Jersey, 07670. I am currently employed with Tillinghast, Nelson and Warren, consulting actuaries in the New York office.

Q. What is your position at Tillinghast?

A. I am the Vice-President and also a principal of the firm.

Q. As I informed you, Mr. Lindsay, it has been customary for witnesses to refer to notes to describe their educational experience and their professional experience as well as their work experience.



Would you first recite for the Court a summary of your educational experience and your professional experience?  
[1788] A. Yes, sir.

I received a bachelor of science degree cum laude from the City College of New York in 1955.

I majored in actuary science, which represented the combination of mathematics and economics.

I became a fellow of the Society of Actuaries in 1962, after completing successfully the eight exams required for fellowship.

I became a member of the American academy of actuaries in 1965.

I received a designation Chartered Life Underwriter of the American College of Life Underwriters in 1969. This required completion of five examinations.

I became a fellow of the Canadian institute of actuaries in 1972.

In 1969 I attended an executive program conducted by the Columbia Graduate School of Business, which involved the study of economics as well as business matters.

In 1978 and 1979 during the summers I attended the advanced management program of the Harvard Graduate School of Business. This program focuses on the development of executives and gets [1789] involved in areas of business management, planning, financial analysis and related subjects.

Professionally, I have participated in several committees:

I was a member of the Examination Committee of the Society of Actuaries serving on the Part 7 Committee for three years and Part 6 Committee for one year.

Also I prepared numerous short answer and essay type questions for the examinations.

I was consultant to the educational committee when the exams were restructured.

I have been an author of several study notes on financial statements.

I served on the Society of Actuaries Committee on Ordinary Insurance and Annunities, whose main purpose is to study mortality of insured lives.

I served as secretary and vice-chairman of the Joint Actuary Committee on Financial Reporting Principles. This was a committee that was established by the joint boards of the Society of Actuaries, American Academy of Actuaries, Canadian Institute of Actuaries and Casualty Actuary Society in order to respond to the audit guide prepared by the American Institute of Certified Public Accountants for stock [1790] life insurance companies.

I served on the Committee on Annual Statements and Valuation of Securities of the American Council of Life Insurance.

I served as a member of the Corporate Planning Committee of the Life Office Management Association, and also served as Mutual Life Insurance Company of New York's representative for that association.

With respect to the Federal Employees Group Life Insurance Plan there is a conversion pool that is established for members who convert their insurance, and I was a member and then chairman of the conversion pool managers for that conversion pool.

With respect to the New York State retirement plans, the state controller of New York years ago established an actuarial advisory committee that would meet with the controller at least twice a year to advise him on any changes in the plan or the funding of the plan. I was a member of that advisory committee.

I also served in various capacities for the New York chapter of CLUS, and also have participated in the New York Actuaries Clubs in several capacities.

I have participated in workshops, panels and [1791] so forth for the Society of Actuaries Life Office Management Association and a few other organizations.

I also have taught on several occasions, for example, this Monday I gave a short one-day seminar for the students for Part 7 of the actuary exams.

Q. What is Part 7?

A. That gets into the pricing of the product, and pension plans, as well as federal income tax, and my course, my discussion concentrated on the distribution of surplus to policyholders as well as federal income tax of life companies at the corporate level.

Q. Have you ever testified in Court before today, Mr. Lindsay?

A. No, I have not. Shall I go on with my business background?

Q. Please do. Employment and work experience.

A. Okay, yes.

I was originally employed by Mutual Life Insurance Company of New York in 1954 as actuary trainee during the summer. I rejoined the company in 1955 and then went into military service for two years.

I returned in 1957 and was assigned to the mathematics section of the Actuary Department and worked on individual product development.

[1792] In 1958 I shifted to the actuary programming unit, and was responsible for preparing the programs and completing the work for valuing group products, this is establishing year-end reserve liability for groups.

1959 I became supervisor of a new section called the special calculation section, which was a small unit, about six people. Our function was to perform all actuary work pertaining to individual health insurance. What I mean by actuary work is the preparation of rates, the determination of dividend scales, the calculation of year-end reserves, and also financial analysis and projections throughout the year.

The other portion of the work in this section dealt with group insurance and annuities.

We were responsible for determining the formulas, performing the experience studies and also the case calculations of all dividends on group insurance and group pension cases, and one segment of this was association business.

We also did the group valuation work, that is calculate the year-end reserves for all group business.

In 1962 I became a Fellow of the Society of Actuaries. I shifted responsibilities, and then was [1793] responsible for preparing the actuary portion of the annual statement and projecting the overall company financial results. Part of this job entailed analyzing the gains by source for the various lines of business.

1967 I shifted back into the product area and was responsible for all individual life and annuity product pricing, including the determination of dividend scales.

1969 I was advanced to second Vice-President and resumed responsibility for the annual statement work as well as for the group actuary work.

In 1971 I was appointed Vice-President of Actuary and was the department head of the Actuary Department so essentially I had all the functions performed by the department in my area of responsibility.

The company reorganized in the beginning of 1974 and I became Vice-President for Corporate Finance. The main responsibilities of this department were corporate accounting and corporate actuary work which means the preparation of all financial reports for the corporation, including the annual statement, as well as projecting results for the corporation.

Another division within this department [1794] was income tax, we did all the tax planning and compliance work for the corporation.

1975 I became Vice-President for Group Insurance. As Vice-President I was line of business head and had all functions pertaining to Group Insurance reporting to me with the exception of the marketing of traditional employer-employee benefit plans. As line of business head my responsibility was to formulate the plans for that line of business as well as to be sure that steps were taken to fulfill those plans.



One of my actions was to recognize the potential benefit to the company of the association plan market, in particular professional associations, because I tied in very closely with our individual sales.

One action I took was to establish a special division within the Group Insurance Department that would concentrate its efforts on the development of this particular market.

In fact just looking at the actual results from the time I became group Vice-President in 1975 until the present time, the volume of business on group association cases has probably sextupled.

In late 1976 as a result of another [1795] reorganization of the company which was caused by the untimely death of our President I became Vice-President of Group Pensions. Then shortly thereafter, in the early part of 1977 I was appointed senior Vice-President and chief actuary.

In that capacity I had two roles, one was to be chief financial officer of the company. That is to have an overview of the financial operations of each line of business, and to work with the various line heads in formulating their financial plans, which hopefully would achieve the desired corporate results.

The other hat was as senior officer, where I had four departments reporting to me: Corporate finance, E D P, corporate services and individual actuary.

In June 1982 I left Mutual of New York and joined Tillinghast, Nelson and Warren as an actuary consultant.

Q. During the time you were at Mutual of New York what was the company's position relatively in the association group market?

A. We saw the association group market as a very high potential market for our operation, and endeavored to obtain a much more substantial market position. So we took the steps in the mid 1970s to [1796] aggressively pursue that market.

I would say at that point Mutual of New York has a relatively strong position in the professional association market.

Q. How strong was that position at the time you left Mutual of New York?

A. It was reasonably strong. Because at that point I think our total premium income was on the order of \$80 million, and I think we had well over 80 cases in force.

MR. GREGORY: Your Honor, Plaintiff offers Mr. Lindsay as an actuary expert in the theory and practice of group life and health insurance.

MR. MARKHAM: No objection, Your Honor.

THE COURT: Okay, Mr. Lindsay is so qualified.

MR. GREGORY: Thank you, Your Honor.

BY MR. GREGORY:

Q. Mr. Lindsay, Mutual of New York is a mutual insurance company?

A. Yes, sir, it is. In fact it was the first mutual company to offer participating group business. We started in 1842.

Q. What is participating business?

A. The nature of participating business is that [1797] the policy owner is provided insurance at net cost. In effect the profits of the organization flow back to the policyholder.

Q. Are you familiar with the term divisible surplus?

A. Yes, I am.

Q. Would you explain it from your perspective and tell the Court how it is allocated among classes of policyholders?

A. The basic principle of participating business is that each class of business is self-supporting and that insurance is provided at cost. The process that a company goes through in determining divisible surplus is first to look at the overall financial position of the company, because the



solvency of the company and its ability to fulfill the guarantees on the contracts certainly is the first consideration.

So going through the process that we normally go through during each year we would first determine how much surplus do you need as a minimum to meet the risks to which you are exposed.

Secondly, you would look at the projection of the financial results for the company under the current dividend scale over the next five to ten years, [1798] and then finally you would determine the portion of divisible surplus that would be allocable to policyholders. And normally the allocation process follows formulas that have been set by the actuary that reflect the contribution of each class of policyholders to divisible surplus. And so, for example, in the case of the individual lines you would recognize an interest gain, mortality gain, and perhaps either a loss from expense or gain from expense.

On the group side, the Group Insurance, there are several factors to consider. One is the size of the case. The bigger the case the more credit you can give to the actual experience in that case.

On the smaller cases, the credibility of the case is smaller, so you cannot truly reflect the experience of that case in determining the divisible surplus.

But the main objective, though, is to return to the policyholders a significant portion of divisible surplus. When I was at MONY we essentially tried to distribute between 80 and 90 percent of the gain for the year back to the policyholder as dividends.

Q. Are you familiar with the phrase "experience [1799] refund," "experience credit," "retrospective rate refund"?

A. That is the — experience refund is the same as a dividend. It is the process that the stock companies go through in allocating back to group policyholders the

divisible surplus on their products. As a practical matter they have to, in order to be able to compete in the marketplace.

Q. For a large group such as American Bar Association is there any practical difference in the dividend to the policyholder paid by an experienced life insurance company and the experience credit paid by a mutual casualty company?

A. None whatsoever.

Q. Where are the elements involved in the computation of dividends or experience credit?

A. In a group case such as American Bar Endowment you must look at all elements of income as well as disbursements. So certainly the premium generated by the policy is the first ingredient. And if a case has a high premium level, that would naturally lead to a higher dividend and so forth.

The second element would be any investment earnings that the company earns on the funds generated by the case. Usually reserves are established for [1800] fluctuations. You have a normal pattern of cash flow throughout the year on a case, and on a case this size you would reflect the investment earnings of the company on those funds.

On the disbursement side you have claims going out, and of course the claims on a particular case depend on a lot of factors, one being the composition of the policyholders in terms of age or sex, the extent to which new lives are brought into the case versus having old block of business, the more new lives you bring in normally the better the experience would be because you have the advantage of the selection process at issue.

The nature of the benefits certainly would affect the total claims cost.

Another element of disbursement would be the expenses of the case. This involves the commission that you would pay to the broker in obtaining the business, fees paid to

outside administrators that handle the processing of the business as well as claims, any home office costs that would be incurred on this particular plan, such as underwriting, preparation of experience analyses, and related items.

Another term would be any income tax that the company incurs with respect to that case.

[1801] Q. Why would the company incur income tax with respect to the case? Is this federal income tax?

A. Yes, federal—well, we have two taxes; one is premium tax which you certainly would reflect, and the second is income tax.

For example, under the current tax law, which is called TEFRA, most of the mutual companies would be taxed on gain from operations, but according to the tax law they would not receive full deduction for any dividends paid back to policyholders, they would receive a credit equal to 77 and a half percent of those dividends.

So the net effect is that if you wanted to return as a company the full gain as dividend, you can't because you incur a tax on that. So effectively under the current tax law mutuals would wind up paying, say, 84 percent of the gain as dividends and 16 percent would go out as income tax.

Q. Are there any other elements of expense?

A. Well, certainly claim expense, but that would be either at the company level or at the broker level.

Q. You testified that part of your responsibilities at various times at MONY was the preparation of the NAIC annual statement. Would you [1802] explain briefly what that is for a life insurance company?

A. Yes. Each life insurance company must file with its home state as well as all the states in which it is licensed to do business a statement according to the form required by the National Association of Insurance Commissioners. Now, there may be some variations by state.

This statement shows a tabulation of assets as well as the various displays which lead to the gain from operations and the determination of total surplus of the company.

This annual statement also shows gains by the various major lines of business such as individual life insurance, Group Insurance, and so forth.

Q. Does the annual statement contain a page reflecting income to the insurance company and expenses of operations?

A. Yes, it does.

Q. Mr. Lindsay, under NAIC accounting principles are dividends to policyholders or experience credits ever reflected as an expense of insurance operations of the company?

A. No, they are not.

Q. And why not?

[1803] A. Because they are divisible surplus of the company. In other words, they are determined according to formulas that the company has developed based upon the experience of the company.

Q. Let me direct your attention to Group Insurance. How do you as an actuary go about evaluating a group insurance policy, determining, say, the fair market value of the group insurance policy?

A. It is fairly standard that the fair market value of Group Insurance would be the premiums paid for the coverage minus any dividends recovered.

Now, in the case of ABE, in which expenses are incurred outside of either the insurance company or through a broker administrator, you should add in the cost incurred in handling the insurance program.

On a normal case, the broker would be performing these services and those services would be one of the expense items that would be reflected in the dividend formula itself.



Q. So the costs of administering the case, as you described it in a normal case would be included as an expense factor in the dividend or experience credit formula?

A. Yes, sir.

Q. Mr. Lindsay, in a case such as the American [1804] Bar Endowment where the individual has assigned dividends and experience credits to the Endowment for charitable purposes, how would you value the ABE group insurance policy?

A. I think it would be the same. In other words, the cost, or the value of insurance is the premium minus dividend plus the cost of operating the insurance program.

Q. Does it make any difference in your analysis if the individual does not year by year actually receive the dividend or have his premium lowered?

A. No, it does not.

Q. Based upon your experience as an actuary in a mutual insurance company, your education and background, Mr. Lindsay, to whom are dividends or experience credits paid in association Group Insurance cases?

A. They are returned to the participants in the case as refunds of premium.

Q. Are they ever utilized to lower premium costs or increase benefits?

A. Yes, they are.

Q. And how many association groups did Mutual of New York have at the time you left?

A. About 80.

[1805] Q. Was there a single group of Mutual of New York that did not return the premiums to the members?

A. No, they were all returned.

Q. In your opinion, Mr. Lindsay, is the actual practices of groups referred to at Mutual of New York consistent with actuary theory with respect to dividends and experience credits?

A. Yes, it is.

Q. Would you explain your answer?

A. The theory is that the policyholder—or the person who is paying for the insurance should get that insurance at cost. And so the dividends should be returned to that particular policyholder.

Q. To your knowledge, Mr. Lindsay, is there any insurance law that requires this result?

A. New York, I believe, under Section 204 for group life insurance—it may be Section 221 for group health—requires on association plans that all dividends, net of any expenses incurred through operating the insurance program, be returned to the policyholders.

Q. Do you know whether the New York law has extraterritorial effect, or to put it another way are you aware of any other states that require this result in their insurance laws?

[1806] A. There probably are some, but I am not familiar with the laws of the other states.

Q. Are you a lawyer?

A. No, I am not.

Q. As an actuary, did you have responsibilities for being familiar with insurance laws as you understood them?

A. I certainly tried to keep aware of developments in law, particularly in New York law.

Q. Have you ever made any investigation, Mr. Lindsay, unrelated to the insurance law, as to whether principles of common law, that is non-statutory law, would require the return of dividends or experience credits to the members of an association absent an agreement on the part of the members that the dividends are or experience credits be utilized in some other way?

A. I have not studied the law, but it is common practice in professional association business, and I think it is a very accepted practice.



Q. In your experiences at Mutual of New York, did you have occasion to become acquainted with third-party administrators?

A. Yes, I did.

Q. And third-party administrators that [1807] specialize in the professional association group market?

A. Yes, I did.

Q. Can you identify some administrators who come to mind who are active in this market?

A. Ter Bush & Powell handled a few of our cases. John Pearl. MICA, which I think stands for Mass Insurance Consultants and Administrators. Smith-Sternan.

I am trying to remember the full name, but we had an individual by the name of Shepherd that we had done work with, but there is a three-part name to the firm and I can't recall the other parts. That was some of them.

Q. Did Mutual of New York do work with James Group Service?

A. Not in the association area. We did have some cases with—I think Fred S. James as a broker on some employer-employee plans, but not on association plans.

Q. Based on your experiences, Mr. Lindsay, can you tell the Court what functions were required to conduct the third-party administration business?

A. The third-party administrator would normally process applications, do some preliminary underwriting, [1808] prepare bills and follow up on bills, do the premium billing and accounting, deal with correspondence from members, process reinstatements of coverage, if the person had lapsed his policy; quite often the administrators would do claims work, particularly on the health side although the life company usually would pick up the claims work on accidental death and dismemberment claims because of magnitude and the cause of death.

The administrator would also be responsible for giving an accounting to the insurance company of the income received in the form of premium payments and the claims

work as well as the statistical information that the insurance company needs in order to establish claim reserves on the case. This is particularly important with respect to health insurance coverage.

The administrators also would be involved in the distribution of the dividends to the participants in the case after the insurance company has determined the amount of dividend to be disbursed.

Q. Would third-party administrators—strike that.

How were third-party administrators compensated by Mutual of New York?

[1809] A. The compensation pattern varied by the nature of the case, the size of the case, the type of the association, the extent to which the administrator had more influence with respect to the association, but by and large the compensation was as a percentage of premium.

For example, on the very small cases—I shouldn't say very small, but say cases under \$500,000 of annual premium you might have a pattern of service fees on the order of seven to 10 percent; the premium depending on the coverage provided.

In addition, if the broker—if the administrator is also performing the brokerage function he would receive commissions, both in the first year as well as renewal years. And the first-year commission might be on the order of, oh, 10 percent, which would mean that the first-year compensation would be when you add the commission plus administrative fees, perhaps 18 percent or so.

Then the renewal years, the compensation would be somewhat less.

Now, in the bigger cases, again depending on the nature of the case, but quite often the pattern would be a declining percentage of premium, administrative fee as well as commission. For example, [1810] one schedule I am aware of, we paid 10 percent of the first \$500,000 of premium; I think seven and a half percent of the next 500,000, and so

on down to 5 percent of any premium in excess of \$5 million. So, for example, in a case that had \$10 million of premium the total allowance for administrative services would be on the order of five to six percent.

Then in addition of course we paid commission, and that too was graded by size.

Q. Could you state for a larger case, let's say \$10 million or above, what your experience was at Mutual of New York in terms of total compensation for both administrative services and brokerage functions?

A. Again, it varied by size of case and how new the case was. But for an established case, those two together I think represented between eight and a half and twelve percent of premium.

Q. Do those figures include the cost of processing and paying claims?

A. Yes, they do.

Q. By how much would they be reduced if the claim function were not included?

A. Again, it depends on the size of the case. For a very large case, processing of life claims, cost between one and two percent of premium. On the health [1811] insurance cases, health insurance coverage like major medical the cost would be from three to five percent of premium. So in a large case you might have a claim cost of two to three percent of premium, if you had a reasonable mix between say life and health insurance coverage.

Q. At my request did you review the proposal of James Group Service to take over the administrative functions of the American Bar Association case?

A. Yes, sir.

Q. Did you examine the proposed dollar figures of James Group Service?

A. Yes, I did.

Q. My question is whether based upon—excuse me. Based upon your experiences at Mutual of New York are you able to state whether the total dollar proposal by

James Group Service was in the range of proposals, dollar proposals that you would have expected for a case the size of the Endowment, considering the type of insurance offered by the Endowment and other factors displayed in that report?

A. That certainly was in the ball park, yes. It was reasonable. In fact you sort of wonder if the Endowment put the case out to bid whether it could not [1812] get a better offer than the James offer, because a component of the James offer was a profit of, I don't recall the exact amount, but between 20 and 25 percent, and I think with a case that would be as attractive as the American Bar Association the Endowment probably could get other administrators to take it at a smaller profit, given it's a prestigious case.

Q. Are you familiar with situations where larger groups have asked for competitive bids from third-party administrators?

A. Yes, in fact that is one reason why you have a change in third-party administrators from time to time on given association cases. I think there certainly is pressure to reduce the costs.

Q. At our request, did you look at the rates charged by the insurance companies on the American Bar Association programs in an effort to determine whether you or your firm could state whether the rates were reasonable or competitive in the marketplace?

A. I did some preliminary work with respect to the life coverage, where it is a little easier to compare rates for life coverage than it is for the other coverage.

I also compared rates to some extent on the AD&D coverage.

\* \* \* \* \*

[1839] Q. I would like you to define it.



A. I would say this, that if the American Bar Endowment rates were lower, I would imagine they would get much more participation in the plan. So from that point of view they were less competitive than they could have been in order to attract more business.

Q. Well, as an expert in the marketing or design of Group Insurance plans, do you have some feel as to what type of a rate schedule just won't go in the marketplace, and if so was the Endowment's rate schedule in that class, or was it within the competitive marketplace?

A. *Well, obviously it wasn't without the marketplace, otherwise it wouldn't have sold at all.* But if that case were being covered by Mutual of New York I would have strongly recommended reductions in rates on a regular basis in order to bring in more new lives, because in the long run you must, you know, bring in a steady flow of new lives in order to obtain a favorable mortality result as well as to keep the expense rates down.

Q. Did all of the other plans you compared pass dividends through to members?

A. To my knowledge, yes, either as dividends [1840] themselves or as increase in benefits.

Q. For the other plans, did you compare the margins of gross premiums above the sum of claims costs plus expenses?

A. No, I did not, because that information was not available for the other plans.

Q. Do you believe that an individual shopping for insurance, or in the market to buy life insurance, would be aware of the dividend rates being paid on various plans that he might be considering, or would he be more likely just to be aware of the gross premiums being charged for those plans?

A. Well, he would certainly be aware of the gross premiums being charged. But I would think an intelligent buyer, which you know I presume lawyers would fall into

that category, would be aware of the participating nature of the business and the dividend potentials. In fact I think, you know, many articles in the press have stressed the net cost of insurance, not just for plans of this nature, but in general, you know, cash-value type plans. So I think the population in general is getting more knowledgeable about the cost of money and the net cost of products as opposed to pure gross premiums.

\* \* \* \* \*

[1883] BY MR. MARKHAM:

Q. Mr. Lindsay, if it is your opinion that the cost of insurance under the Endowment's plan is the gross premium minus dividend, why did you make comparisons based on the gross premium of the Endowment's plan versus the premium net of dividends on the other plans with which you compared it?

A. The real purpose arose from counsel's contention that the government was focusing on that measure. In other words, the gross premium of the ABE plan versus the net cost of other plans. And that is the main reason why I compared plans on that basis, you know, on the limited basis that I did.

Q. Earlier this morning I read to you from paragraph 9 of your affidavit, which I will show you a copy of, which I believe you prepared in connection with summary judgment proceedings in this case.

In that paragraph you stated that "numerous professional groups and associations in the United States sponsor group insurance programs in which any premium refunds are returned to members or are used for their financial benefit. Since the American Bar Association, ABA, has not chosen to do so, those ABA meetings who participated in the Endowment's Group Insurance program have paid more for insurance than [1884] they would



have if the ABA had determined to adopt a program whereby premium refunds are returned to members enrolled in that program."

As I understand your last answer to Mr. Gregory, you no longer think that the cost of the members who enroll in the Endowment's program is the amount that they paid for their premiums; is that correct?

A. Well, the net cost of any insurance program is the premium less dividends; the way of looking at it. And of course the Endowment members have the option—well, they don't quite have the option, but when they signed up for the insurance they elected to contribute any dividend coming back on that coverage to the Endowment.

Q. Correct me if I am mistaken, but I would read the second sentence in paragraph 9 to be a statement that the members are paying more for insurance, and that is because they are paying a gross premium and not getting any refund. Didn't you mean to indicate that the gross premium was paid for insurance?

A. I will admit it is not clear as it could be.

\* \* \* \* \*

[1929] Whereupon,

WARREN D. GARDNER

having first been duly sworn, was called as a witness herein, and was examined and testified as follows:

DIRECT EXAMINATION

BY MR. DENNIS:

Q. State your name for the record please?

A. Warren D. Gardner.

Q. And your address?

A. 12430 Myrna Road, Kansas City, Missouri.

Q. And what's your age?

A. Forty-nine.

Q. Mr. Gardner, are you testifying here on the basis of a subpoena?

A. Yes, I am.

Q. And have you entered into an expert witness agreement pursuant to the advice of your counsel?

A. Yes, I have.

Q. Are you receiving any compensation from the government in this case?

A. My expenses are being reimbursed by the government.

Q. No other compensation?

\* \* \* \* \*

[1953] [GARDNER—DIRECT] A. If the association is taking a profit out of the case, it would have the effect of increasing the premium somewhat for the members.

But again, because of the economies of the delivery system itself versus the cost of individual insurance where a commission of 50 percent or so is certainly common, it could be even with the association receiving this remuneration, still could be a good economic purchase for the individual member.

Q. Would the selection process also have an effect on that?

A. Yes, it would have somewhat of an effect.

Q. What about the size of the group?

A. Certainly the larger the group, the more potential market you have, the more volume of insurance you can sell, has an affect on it. Yes.

Q. On the rates charged?

A. Certainly.

Q. Have you had occasion to work with lawyers in purchasing insurance?

A. Yes, sir, I have.

Q. Can you describe what that experience has been?

A. Our company has for some 30 years been the administrator for the Missouri Bar Plan. We were also the [1954] administrator for the Kansas Bar Association.

I personally handled the Missouri Bar account for some six or seven years in the 1970's. As such, I worked closely with the staff of the Missouri Bar, the insurance committee of the Missouri Bar, and as such with many of the individual members of the Missouri Bar.

Q. Would you describe attorneys as sophisticated buyers of insurance?

A. Well, if you're contrasting attorneys in relation to the general population, they are certainly more sophisticated than the general population.

In my thinking of the sophisticated purchaser of insurance, my experience says, no, they are not.

Q. And why—

A. Well, there are many reasons. One, they are very busy people. They do not have the time to take and evaluate all the technical aspects of an insurance purchase.

It's been my experience that many of the members of the Missouri Bar, that they don't even read their policy. They really don't know what they have.

We, for instance, we audit. Take and send an audit out every year, telling them what policies and what coverages they have. We do that with all our people, but also with the Bar.

Q. Do you feel that an attorney is capable of [1955] calculating the net cost of his insurance?

A. Certainly some of them are, but I would say the vast majority of them will not have the inclination nor the technical ability to figure out what the net cost of a certain insurance product is.

Q. For association insurance, do you think an attorney lies extensively upon representations made to him in the advertising brochures?

A. By his association?

Q. Yes.

A. Certainly.

Q. This would depend upon the credibility of the association?

A. Well, certainly. Credibility in the marketing of association insurance, the first thing we look at in the association is the credibility factor that association has with their membership.

They have a high credibility factor, you will be more successful than if they have a low credibility factor.

Q. That's a key consideration in your decision whether to come in and market insurance to a group?

A. Absolutely.

Q. Now at my request, have you reviewed the testimony given by Plaintiff's director of publications in this case, Liz Locke, and the advertising materials introduced into [1956] evidence through her?

A. Yes, I have.

Q. Can you comment upon the professional character of the ABE's advertising exhibits?

A. Highly professional. Very good stuff, very attractively done. Very professionally—

Q. Can you contrast that with other association advertising?

A. Well, certainly, of all the association advertising I have seen over the years, it would certainly be in the top percent.

Q. Now, Ms. Locke testified that she used a number of phrases in her advertising materials. Valuable basic insurance designed especially for lawyers. Modest group rates. Economic group rates. Exceptional opportunity to have valuable protection at modest costs.

Are these phrases used over and over again in advertising?

A. Yes, sir. They are—if you want to use the term, "buzz words" in our industry, certainly. You have to understand, Mr. Dennis, that the advertising aspect of direct marketed mass marketing insurance to associations is a very sophisticated and refined business.

These phrases of this type have been tested time and again, and tried time and again. They're in there for [1957] a purpose.

Q. And what's the purpose?

A. The purpose is to get someone to purchase the insurance.

Q. Now would you use the phrase, "This is the best rate on the market"?

A. No, sir, I would not.

Q. Why?

A. Anytime you make a definitive absolute statement like that somebody is going to make you prove it.

Q. Why would that be?

A. Because there is no way that you can take on any given instance and say that you have the absolute best rate on the market.

Q. Are there any laws precluding you from doing that?

A. NAIC model advertising guidelines would specifically prohibit something like that.

Q. State advertising laws?

A. State advertising laws.

That is taking factors you have not gone to the trouble of proving beyond a shadow of a doubt that that is a true statement. If it's a true statement, you can say it. But you have to prove it.

Q. And you'd have to do it before you made the statement?

[1958] A. Some states require prior approval of advertising material.

Q. By the—

A. By the NAIC. Or by the regulator in that state.

Q. In your opinion, is it possible for an association to create a market for insurance through sponsorship, solicitation, promotion and advertising?

A. Yes.

Q. Can you explain how they would do this?

A. By many factors that you would look at. Again. I'll go back to the first one that I talked about a little bit before, and that's the credibility factor that the association has with its members.

If it has a high credibility factor that is very important. Next, you would look at the make up of the association. What is the membership's profession? Is it a highly desirable profession that the insurance industry wants to reach?

Secondly, is it a large association and does it have a substantial number of the overall members of the profession in the association.

All those aspects are true. Certainly the association can, in fact, make a market.

\* \* \* \* \*

[1977] [GARDNER—CROSS] Q. You were provided application forms for the insurance policies?

A. Yes.

Q. Were you provided by the government any documents concerning the history of the insurance program?

A. What do you mean by the history, sir?

Q. Do you recall any documents called, "The Endowment Story"?

A. I don't recall any one especially like that, no, sir.

Q. Do you recall the government showing you the annual notice to members of contributions by insured members?

A. I saw one that was a copy where there was a—oh, maybe like a three by eight card or something of this type, that had percentages of contribution to the membership.

Q. Let me show you what has been marked as Exhibit 201, and ask if that is the card you're referring to?

A. I'm not sure it's this exact one. I think the percentages on the one I saw were a little different, but it's certainly similar to this. Yes, sir.

Q. And that refers to a percentage that the Endowment calls a contribution to the Endowment. Is that correct, sir?



A. I think it's called, "tax deductible portion of [1978] premium."

Q. In the body of that card talks about a percentage contribution made by Endowment members to the Endowment. Is that correct?

A. It—made a contribution to the Endowment. Yes, sir.

Q. And that card is 1979. What percentage figures are shown on that card?

A. Forty-point-five percent of any life insurance premiums.

Q. And now would you list for me, Mr. Gardner, the other association groups that you're aware of that send a similar card to their members at the end of the year?

A. I'm not aware of any other associations that send a similar card of this type to their members.

Q. Is it not a fact, sir, that this card discloses what you've described as profit, on the part of the Endowment to the members?

A. Yes, sir.

Q. Would you please name for me the mass marketed insurance programs of which you are aware that send by separate mailing each year a statement of the profitability of the program for those insured under the program?

A. I'm not sure I understand your question. Of any association plans that report on the financial aspects of [1979] the plan to their members?

Q. That wasn't my question. Let me see if I can't break it down with a bit more precision for you.

It was quite a bit of confusion in the testimony concerning mass marketing, association, et cetera.

Let me direct your attention to professional association. You used "association" generally. I'm going to talk a lot about professional associations.

Please list for me professional associations of which you are aware that report to the members each year on a separate mailing exactly the amount of dividends retained by that association.

A. I know of no others.

Q. And, of course, you don't know of any credit card program that discloses anything about its profits to the insured members. Do you?

A. No, sir.

Q. And you don't know of any credit life insurance program that would disclose the amount of profits to the insured member—to the insureds on an annual basis, do you?

A. I do not.

Q. Because that is inimical to the marketing strategy of credit life insurance. Is that not correct, sir?

A. It certainly is one of them, yes, sir.

\* \* \* \* \*

[1988] [GARDNER—CROSS] A. That's a possibility.

Q. Is it not a probability?

A. Not always.

Q. Would you expect the same percentage of premiums paid on a 15 million dollar case as on a 100,000 dollar case?

A. There are some that are.

Q. All right. Give me an illustration.

A. There would be an example—you're asking for a specific association?

Q. Yes, sir.

A. I cannot give you a specific association, Mr. Gregory.

Q. Does Forest T. Jones Company administer the Missouri Bar insurance plan?

A. Yes, sir, they do.

Q. And this is a major medical plan, sir?

A. It is.

Q. Would the initial deductible of about 2500 dollars?

A. No, sir.

Q. All right. What is the deductible?

A. There are various deductibles, starting at 200 dollars.

Q. The option on the part of the members?

[1989] A. Yes, sir.

Q. And Missouri Bar is a professional association?

A. Yes, sir.

Q. And the National Society of Public Accountants was a professional association?

A. Yes, sir.

Q. And was that plan in existence when you were at Forest T. Jones?

A. Yes, sir.

Q. Is it not a fact that the average premiums were approximately the same as the National Society of Public Accountants?

A. I would have no way of knowing that.

Q. Well, were you familiar with that plan when you were at Forest T. Jones?

A. I was familiar with the plan.

Q. One-point-one million average, sound strange to you?

A. Probably not.

Q. Now this is strictly a major medical plan.

A. It is strictly a major medical plan.

Q. And with deductibles as low as 250 dollars?

A. That is correct.

Q. So at least at that level, that's certainly not a catastrophic major medical plan?

[1990] A. That is right.

Q. At least with some people.

A. You're using the word "catastrophic" in relation to excess?

Q. Excess. This primary coverage at 250 dollars?

A. That is correct.

Q. And primary coverage, at least what I would describe as first dollar coverage. Is that a fair statement?

A. Fair statement.

Q. All right.

And about one-point-two million or so in premium. Can you recall what the average brokerage commission would be for Forest T. Jones on that case?

A. It's higher for new business than it was for renewal. And I'm thinking somewhere, maybe in the area of 10 percent new business, five percent renewal.

Q. Would it surprise you if the average brokerage commission over a three year period were seven-point-five percent?

A. No.

Q. And would it surprise you if the service fee averaged over a three year period about nine percent?

A. No.

Q. And that's 16.5 percent to Forest T. Jones?

A. That's correct.

[1991] Q. And that includes payment for claims administration?

A. That is right.

Q. Now what, if anything, do you know about the dividend history of the Missouri Bar plan?

A. I know of nothing on the dividend history.

Q. Now is it experience rating?

A. Yes.

Q. And do you know how dividends have been applied?

A. If there were any dividends payable, they would have been applied back to the benefit of the members.

Q. Members of the association?

A. Yes, sir.

Q. Not to the bar?

A. No, sir.

Q. And New York Life paid no compensation to the Missouri Bar for sponsoring this plan?

A. That is absolutely correct.

MR. GREGORY: I'm going to go into a different subject, Your Honor. Would it be convenient to break now?

THE COURT: That'll be —

See you at 2:00.

(Whereupon, at 12:00 Noon, a luncheon recess was taken.)

\* \* \* \* \*

[2015] [Gardner—Cross] Q. What about disclosure of the substance of the program? What's done with the money?

A. They are not similar.

Q. They're entirely different, isn't that correct?

A. I would say so.

Q. And, it's also entirely different from association groups that don't talk about what happens with any profit retained by the association, isn't that correct, as far as disclosure is concerned?

A. As far as disclosure is concerned?

Right. It would have to be different.

Q. That's right, because the American Bar Endowment discloses all aspects of the financial operation of the insurance program and credit card insurance discloses none to the consumer except the gross premium, is that correct?

A. That's correct, but does that have any ultimate affect on the price of the product?

Q. I'm going to show you, sir, a document which has been designated as Exhibit 376. This is in evidence. Let me show you the one that is actually the document, your Honor.

THE COURT: I think I have one of these.

MS. CARPENTER: If Judge Kozinski does have one, [2016] maybe the witness would want to look at it.

THE COURT: Why don't you give this one to the witness.

MR. GREGORY: Thank you.

BY MR. GREGORY: (Resuming)

Q. I'm going to ask you, sir, to just look at that brochure and open it up, turn to the page, the purpose. Just read that page.

(Pause)

A. Yes, sir.

Q. Now, would you turn to page three and there's a box. In the box it says that there's a special enrollment period which will terminate October 15, 1972. Now, do you think it's logical for us to agree that this brochure was distributed prior to October 15, 1972?

A. I can almost bet it was.

Q. I wouldn't take the bet. Can you name one other insurance program, any kind anywhere in the association group credit card area and we'll toss credit life or credit ANH right into the hopper on this one, that has ever come even close to making this kind of disclosure of what would happen with dividends and experience credits?

A. I think we've discussed it before. I could not name one.

\* \* \* \* \*

[2020] [Gardner—Cross] Q. And in a forthright manner?

A. I would think so—I would hope so.

Q. And ordinarily wouldn't lie when he testifies as to what his services have been priced at and why?

A. Lie?

Q. Yes, not tell the truth to a client?

A. I would hope so.

Q. You would hope that he would not?



A. I would hope that he would not.

Q. Because you wouldn't, of course not?

A. I wouldn't.

Q. As I understand your expertise and have concurred in it, I might add, as you heard, you're an expert consultant in the area of association group insurance?

A. I would say so.

Q. Let me take you back to 1981. You've gained some familiarity with the American Bar Endowment Plan. How would you have advised the American Bar Endowment to go about selecting a third party administrator in terms of the cost of service?

A. I would developed a set of specifications of all the services that the third party administrator would be expected to perform, each one carefully defined and I would insist that the quality of service be equal to or greater than [2021] the present quality of service that the buyer was furnishing. I would obtain information regarding at least the top ten or twelve administrators in the country and I would give that exact set of specifications to each one of them. And, in addition, I would insist on a long-term agreement with very definitive escalation clauses for the increase in the remuneration to that organization.

Q. And you'd ask these organizations to come in and present, in effect, a competitive bid?

A. That is correct.

Q. Because the ABE insurance plan is large enough that it can be put out in terms of third party administration for a competitive bid?

A. You would have them knocking in your doors.

Q. Because of the competition in the industry?

A. Right.

Q. And, every one of them wouldn't come in at 25 percent of premiums, would they?

A. No, they probably wouldn't come in at three and a half either.

Q. Pardon me?

A. They probably wouldn't come in at three and a half either.

\* \* \* \* \*

[2029] [Gardner - Cross] A. Should be.

Q. Now, you looked before, and in fact told me that you had seen an annual notice from the American Bar Endowment to insured members showing percentage of premiums that had been retained by the Bar as charitable contributions?

A. That is correct.

Q. Now, were you informed by the United States that the American Bar Endowment has been forwarding these notices each year since 1964?

A. I was not informed they had been forwarded each year since 1964.

Q. We'll just assume that. Let's assume that for purposes of my questioning. And, assume that it comes first-class mail. Assume that it's an envelope with nothing else.

Do you think a lawyer is capable of opening the envelope and reading what's on the card?

A. He certainly is capable.

Q. Do you think a lawyer is capable of taking those percentage figures and applying them against his prior premium payments to determine what those percentage figures represent?

A. He's capable.

Q. Do you think if the percentage figures are in the range of 40, 50, 60, 70 percent a lawyer might be motivated to do that?

[2030] A. I think he might be motivated.

Q. Do you think if a lawyer took the premium figures, applied the appropriate percentages, he'd be capable of subtracting that figure from his prior premium payment?

A. Should be.

Q. Do you think a lawyer knows what the American Bar Endowment has retained as dividends and experienced credit?

A. I think so—most of the advertising material at different times tells him that.

Q. I'm going to ask you just a few questions about individual insurance and group insurance. Can you state to me the essential differences between individual insurance and say association group insurance?

A. In individual insurance, the point of sale takes place between the consumer and a broker or agency. The policy that he buys is his individual policy and he selects an amount of insurance to fit his particular needs.

Q. Can you think of any other essential differences?

A. Normally the cost of the product is substantially higher than group insurance.

Q. Is it not also a fact, sir,—Let's look at life insurance. In individual life insurance, the cost of the product is guaranteed in many cases?

A. Yes.

\* \* \* \* \*

[2045] [Gardner—Redirect] A. Certainly if they're members of the state and local bar associations, other national bar associations, and they are the same individual, they're competing for the same insurance dollar.

Q. Does the ABE in marketing its insurance compete with employer-employee plans?

A. No, not on a direct basis.

MR. DENNIS: No further questions.

MR. GREGORY: Just very briefly, Your Honor—

#### RECROSS EXAMINATION

BY MR. GREGORY:

Q. Mr. Gardner, did I understand you to say that this Master Educational Trust went to New York Life on August 1, 1983?

A. Yes, sir.

Q. Let me make sure I understood your cross examination on one point. You're saying that because the members of the American Bar Endowment sign an initial application agreeing that the dividends to policyholders and experience credits will be retained by the endowment for charitable purposes, that that means their cost of insurance is the gross premium?

A. In my opinion, yes, sir.

Q. And you're saying that makes the entire dividend, experience, compensation to the Endowment?

[2046] A. No, not the entire.

Q. The dividend less the expenses?

A. Expenses of administration and marketing.

Q. All right. Now, I think you said that the Bar could consider or might consider—Again, I don't want to put words in your mouth.—an annual option in the members to keep the dividend. Now, if there were an annual option where a member had the option to keep the dividend, you would agree then that the member really did have a net cost equal to the gross premium minus the dividend?

A. If he had the absolute option, yes.

Q. All right. And the American Bar Endowment, in your understanding, receives compensation from no person in the world other than that represented by the dividend and the experience credit?

A. That is true.

Q. Now, if there were—Stay with a short hypothetical with me, please. If there were an annual option on the plan and every member opted to allow the Bar to keep the dividend and experience credit and not a single member asked for it back, would you not agree that the members had made a charitable contribution?

A. You're talking legally as a definition of a charitable contribution—I couldn't address that. From my understanding [2047] of it, certainly.

Q. So, what distinguishes the charitable contribution from what you say is millions and millions and millions of dollars of compensation is the annual option versus the signature of the individual lawyer at the time the application for insurance is made?

A. That's right.

MR. GREGORY: No questions.

MR. DENNIS: Just one more question.

#### FURTHER REDIRECT EXAMINATION

BY MR. DENNIS:

Q. Has the annual option method been used in the mass marketing insurance?

A. It was a marketing thing a lot of us tried back in the mid-'70's as a sales tool to get an association to adopt an insurance program. We would say, — And, we'll set this up so the association can receive any dividends that would accrue and it was a dismal failure.

Q. No one would assign their —

A. Nobody's still doing it. If it had been successful, we'd still be doing it.

MR. DENNIS: No further questions.

\* \* \* \* \*

[2089] MR. WATKINS: Your Honor, at this time the Government calls Mr. James Burnett.

Whereupon —

#### JAMES BURNETT

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

#### DIRECT EXAMINATION

BY MR. WATKINS:

\* \* \* \* \*

[2093] Q. Do you read it?

A. Not anymore. Very infrequently. I sometimes peruse it. But when I was in law school I read it regularly.

Q. Do you ever recall reading reports of the American Bar Endowment in the Journal?

A. I seem vaguely to recall they may have been there. I doubt I read them, because I doubt I had that much interest in them.

Q. Do you ever recall seeing advertisements by the Endowment in the Journal?

A. No.

Q. Have you ever considered dropping your American Bar Endowment membership?

A. Yes, I did in 1981.

Q. Did you in fact drop that membership?

A. No, I did not.

Q. Would you tell us why you did not?

A. Well, I didn't want to lose the insurance programs that I had through the American Bar Association.

Q. What programs are you insured under?

A. Best of my recollection, I have a life insurance policy which I think is \$20,000 in amount. And I have a major medical plan that kicks in over [2094] \$10,000, it begins. I also think I have an accidental death and disability plan.

Q. Did you ever try to buy more life insurance under the American Bar Association program?

A. Not to my recollection.

Q. When you purchased the life insurance under the Endowment were you required to submit any evidence of medical insurability?

A. I may have filled out a form. But I remember one of the reasons I was interested in the policy was that I did not have to have a medical.

Q. Why was that important to you?

A. Well, because some people believe that I am overweight, and I have been concerned about my insurability because of that.

Q. Did you ever try to apply for other life insurance?



A. At one time I applied for a policy through Woodmen of the World through which I have some other insurance that would have allowed me to, I think the marketing phrase was insure your insurability by a specified, per being able to purchase a larger amount of insurance without medical. And I wanted to be sure that I had the option and after making the application they rated me up and I thought it was marginally too [2095] high and I did not take it.

Q. Would you explain what you mean by rated you up?

A. They were going to let me buy the insurance but make me pay a higher rate than I was told that I would have to pay originally.

Q. Do you consider the price you pay for the Endowment's insurance reasonable?

A. Yes.

Q. Have you ever held any higher insurance under the Arkansas Bar Association?

A. Yes, I believe I have 20,000 under that.

Q. Do you know whether you receive any experience rating refunds from that policy?

A. I don't believe so.

Q. When you applied for the Endowment's insurance were you aware that the American Bar Association took the position, on the advice of their tax counsel, that you could take a charitable deduction for part of your premium payments?

A. No.

Q. Did you learn of that at some later time?

A. Well, when I began to receive these little statements that I was entitled to deduct some things, something like that, I became aware there was some tax [2096] issue that related with it, but not understanding tax law I didn't pay a whole lot of attention to it.

Q. What did you do with those notices?

A. Threw them in the waste basket.

Q. Do you itemize deductions on your federal income tax return?

A. Again, not understanding tax laws, I am not sure what you mean itemize deductions, but I think you mean would I state a specific amount for contributions. And yes, I suppose perhaps I have at different times itemized and maybe times I have not itemized.

I know I have in some cases.

Q. Have you ever deducted, as an itemized deduction, any amount attributable to your participation in the Endowment's insurance programs?

A. No.

Q. When you purchased your life insurance was your sole motive to obtain insurance coverage?

A. Yes.

Q. Was that also true with the major medical and accidental death and dismemberment coverage?

A. Yes.

Q. At one time did you hold insurance coverage under the disability and hospital indemnity policies as well?

[2097] A. I don't recall holding the hospital indemnity and disability policy. However, during depositions I was presented with the form that indicated that at one time I did. But my recollection other than knowing that it is true from that documentary evidence is not-existent on that.

Q. Assuming for the moment that you did, would your motive in buying that—would your sole motive in purchasing that coverage also have been to obtain insurance coverage?

A. Yes.

Q. If you had a choice would you rather receive the premium refund yourself?

A. Yes.

Q. Have you ever contributed to the Arkansas Bar Endowment?

A. Yes, I have.

Q. Apart from your participation in the Endowment's insurance program have you ever made any contributions to the American Bar Association?

A. Not to my recollection. I may have, because I contributed in small amounts to a lot of various entities in my life and that could be one of them.

\* \* \* \* \*

[2101] A. Yes, I would. I don't think I could have altered the terms there even if I had wanted to.

Q. I beg your pardon?

A. I don't think I could have negotiated or altered the terms and that would be what I consider boilerplate.

Q. Now, you recall, I believe, getting regular notices from the American Bar Endowment indicating that you had made certain contributions in certain percentage of your premium payments?

A. Yes.

Q. And I believe you testified that you regularly threw these into the waste basket?

A. Yes, I did.

Q. And did I understand your testimony on the deposition that you considered these amounts of these contributions rather negligible?

A. As I recall, they were not large. At least I didn't think they were large enough for me to pay a tax accountant to figure out what to do with them.

Q. It just wasn't worth it to figure out what was the amount of your contribution?

A. Yes.

Q. Did you have a general understanding of the charitable purposes of the American Bar Endowment?

[2102] A. Yes, I had been to at least a mid-year meeting and also an annual convention of the American Bar Association, at which I know the American Bar

Association is discussed. And I think maybe I have seen reports and things that have been drafted under their auspices or research done, so on.

Q. Let me read from the charter and see whether their statement of purpose accords with your general understanding, if I can find Exhibit No. 267.

Was it your general understanding that the American Bar Association was a charitable organization to help to direct toward broadly improving the administration of justice in the United States?

A. That is correct, improving the quality of the bar.

Q. I understand from your testimony this morning that if you could have gotten your contributions back you would rather have had them than to have had them go to the American Bar Association?

A. Yes. And then if I wanted to contribute to the American Bar Association I could have done so. Or I might have taken it and contributed it to the Arkansas Bar Endowment so that I would have had more direct benefit to my home state and community.

Q. Is it correct then to say that you were [2103] happy to enter into the charitable program sponsored by the American Bar Association but were not happy to make the contribution that that entailed?

A. Well, I didn't resent the fact that whatever money was coming back would go to the American Bar Association. Given that if I had had a box to check, I would have checked to have it come back to me.

Q. Is it correct that you indicated in your deposition that the Government would have difficulty in proving that you were a typical attorney insofar as this insurance was concerned?

A. I hope that it is true, that they would have a hard time proving that I was a typical attorney.

MR. THROWER: Well, I have no further questions, thank you.

MR. WATKINS: We have no further questions. Mr. Burnett is a busy man as Chairman of the Board and we appreciate his appearance here today and thank him for his time.

THE COURT: Thank you for your testimony, Mr. Burnett, you are excused.

(Witness excused)

THE COURT: Why don't we take our quick mid morning break, about ten minutes.

(A brief recess was taken.)

[2104] MR. DENNIS: Your Honor—

THE COURT: Was Exhibit 152 moved into evidence or anything like that?

MR. THROWER: No, Your Honor, that was not offered in evidence.

MR. DENNIS: Your Honor, the next witness we would like to call is Angele Khachadour.  
Whereupon—

ANGELE KHACHADOUR

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

Direct direct

BY MR. DENNIS:

Q. Would you state your name, please?

A. Angele Khachadour.

Q. And your address?

A. 817 Ridgeview, Mill Valley, California.

Q. Ms. Khachadour is testifying as an expert witness for the Government this morning, Your Honor.

Are you receiving any compensation—

MS. CARPENTER: Excuse me, Your Honor, she will not be testifying as an expert unless our objection is overruled.

THE COURT: He will offer the witness, I think is what Mr. Dennis meant to say.

\* \* \* \* \*

[2199] BY MR. DENNIS:

Q. What is the net cost of the ABE insurance?

A. To the buyer, to the member?

Q. Yes.

A. It is whatever the member has been charged for the coverage.

Q. Gross premium?

A. Yes.

Q. When you said that the ABE insurance would be a good buy for the member, if the dividend levels were 50 percent would that affect your statement that it is a good buy or could the ABE still provide reasonably priced insurance at that level?

A. My opinion that the product is a good price product is based on what like products are sold for in other group cases. If I compare the ABE life program with the California state bar program, depending on sex and age at the time of entry, I think the comparison would be two products of like value to the member.

So if you are telling me there are dividends of 50 or 60 percent, which makes me choke, still the product in comparison to whatever else is available in the marketplace is good. I look at the value of a program based on what else I can buy.

\* \* \* \* \*

[2209] CROSS-EXAMINATION

BY MS. CARPENTER:

Q. Ms. Khachadour, your task force ultimately determined to treat association groups in a way different from credit card and other discretionary groups; is that correct?

A. That is correct.

Q. And you made a reference in your direct testimony to good guy associations and bad guy associations. Do I understand correctly that the good guy associations were



treated like employer-employee and multiple employer trust groups and the bad guy associations were treated like the discretionary groups; is that correct?

A. It depends, counsel, as to whether the association fit the particular standards of eligibility in that section. If it was in existence for a period of time, if it had dues, if it had by-laws, articles, so forth, it was kind of presumed to be a good type association.

Q. And those criteria would be an association in existence more than two years, formed for purposes [2210] other than obtaining insurance, its by-laws or constitution provided it meet at least once a year, that it collect dues or solicit contributions from its members, that its members have voting privileges and that its members have representation on governing boards of the committees; is that correct?

A. That is correct.

Q. That is what you refer to as a good guy association?

A. Presumed to be a good-guy association.

Q. Presumed to be.

A. Yes.

Q. You had a colloquy with Mr. Dennis about solicitation and selling and you made reference to the fact that only a licensed agent or broker can solicit or sell insurance. Is that correct?

A. Technically, yes.

Q. Is my understanding correct as well that only a licensed agent or broker may receive a commission for selling insurance?

A. Yes.

Q. Do I understand that an association that was not—did not meet the good guy criteria would have to provide benefits that were reasonable in relation to premiums charged?

[2211] A. Yes.

Q. And that was a response to abuses by certain associations and discretionary groups in terms of receiving excessive compensation?

A. Well, the definition of discretionary group, counsel, was a major liberalization of the law. The law was not saying that any kind of grouping is acceptable, however where the group is of such a nature that the organization involved may not have the best interest of the members at heart then we will add this additional standard that the benefits be reasonable in relation to premium charged.

Q. I understand from the report of your task force that there was concern that sponsors of some groups were getting as much as 15 to 20 percent of premium?

A. Yes,

Q. And that was perceived as abuse by your task force?

A. Yes.

Q. Dividends and experience credits are not always compensation under every circumstance, are they?

A. No.

I mean yes.

Q. What?

[2212] A. Yes, that is a true statement.

Q. One of the remedies for reverse competition is full disclosure, is it not?

A. One of the remedies touted by some is full disclosure. I have become very skeptical as to disclosure as remedy.

Q. And another remedy for reverse competition is control by the insured individuals, is it not?

A. Yes, the insured doesn't have to buy the product of course.

Q. And if the insured has control over the organization that serves its group policyholder, that can be one remedy for reverse competition, can it not?

A. Yes.

Q. You used the word "middleman." Where did you get that word?

A. It is an English word, is it not?

Q. Yes.

A. Where did I get that word?

Q. Would you agree it is not a word one ordinarily hears in the insurance industry, the word middleman?

A. I would use it. I have used it a lot to describe the third party intermediate who acts as the source of the insurance for the consumer.

[2213] Q. You testified on direct that generally group insurance is lower in price than individual insurance. Now, are you aware that there has been a very significant decline in the price of individual term life insurance?

A. Yes.

Q. In the credit insurance area. I believe that since the abuses of the 1960's which you discussed, profits of credit insurance companies have been limited by law or regulation, isn't that right?

A. In some states.

Q. And that would include California?

A. Yes.

Q. And those are situations in which there is no control by the debtor of the organization that is providing the insurance?

A. Yes.

Q. And in fact the debtor needs something from that organization, doesn't he or she?

A. Yes.

Q. And there is no disclosure of the profit made on the credit insurance?

A. No.

Q. And there is no disclosure even of the fact of the dividend or experience credit, is there?

[2214] A. No.

Q. Is the reason that the regulatory authorities in some states, including your own, have moved against credit insurance profits the fact that those profits were viewed as excessive?

A. Yes.

Q. And in fact, those profits were viewed as so excessive as to be inappropriate and unethical?

A. Yes.

Q. It is true, is it not, that many professional associations take no money out of their insurance programs?

A. Yes.

Q. And in fact they try to make their insurance programs as cheap as possible?

A. Yes.

Q. And in fact provide their members with very low priced insurance?

A. Not necessarily, depending on the size of the group.

Q. A reasonably large group can provide insurance at very favorable prices, can it not?

A. Certainly.

Q. And some of those associations advertise to their members their past dividend history, do they not? [2215] Always, of course, with the caveat that dividends are not promised, but they do tell the members about past dividends that have been returned?

A. I have seen very few of those. I think the ABE is the exception that does show that. I can't remember seeing association advertising past dividends, no.

Q. Have you ever seen advertisements for the Engineering Associations Trust?

A. No.

Q. Or the Ontario Medical Association?

A. No. There are hundreds of thousands of associations. In California, at least, I have not seen any.

Q. I understood you to say on direct that compensation is anything of benefit to you for giving business to the carrier. That was a general statement not in the context of the ABE. But I want to be sure about one point. Did you mean to imply by that that New York Life is paying the Endowment three, four or five million dollars a year to bring the Endowment's business to New York Life?

A. I should say so.

Q. I think you said in California the profits of credit insurance are limited to 15 to 25 percent; [2216] is that correct? Did I understand you?

A. Yes.

Q. And do you view as anything more than this percentage to be excessive profits?

A. I think we range as high as 32. Depending again. The commissioner deemed anything in excess of that to be excessive, yes.

Q. What did you review in preparation for your testimony today?

A. Not much. I was asked if I had ever seen the bulletin, director bulletin of Illinois, and I remembered it.

I was asked to identify the ruling from California. The NASC report. I was shown copies of the reports I have written as the task force representative on group life and health models, that is about it.

Q. Was the last time you saw an Endowment Brochure 10 or 12 years ago?

A. No, I saw the brochure last year. I received one of the solicitation packages last year.

\* \* \* \* \*

[2219] A. If I have an option to receive the dividend, then after my receipt of the dividend my cost would be the premium I paid at the beginning of the year less the dividend.

Q. You said a dividend in the 50 to 60 percent range would make you choke. Why is that?

A. I can't imagine the rationale for justifying such a dividend.

Q. Did you know a Mr. Theodore Slokum?

A. No.

Q. Do I understand your testimony correctly that there was no consensus reached in your task force with respect to what to do about compensation of group policyholders?

A. That is right. Primarily because it was not the task force's charge at that point when we were considering it.

Q. Do you know anything about the history of the ABE program?

A. You mean its early —

Q. Its origin.

A. Not really, no.

Q. You made some reference to the fact that you didn't think that lawyers read their material. Is it your view that lawyers need to be protected from [2220] themselves in entering into group insurance arrangements?

A. No. That is why we did very little about this and other programs from professional associations.

MS. CARPENTER: If you don't make your plane, talk to Mr. Dennis. That is all, Your Honor.

THE WITNESS: I thank you.

#### REDIRECT EXAMINATION

BY MR. DENNIS:

Q. On cross-examination, the question was asked dividends were not always compensation. When would dividends not be compensation?

A. In an employer payroll program dividends or refunds to the employer is not compensation, it is just the reduction of the premium the employees paid.

Q. And you also indicated that it wouldn't be compensation if it weren't required as a condition of entering into the program, the payment over to the group policyholder?



A. Yes, I would not view it as compensation at that point, no. If I have an election as to what I do with a dividend, my own certificate or my own policy generates.

Q. On the other hand if the member didn't have an option but as a condition of entering the program [2221] was required to waive, then you would feel it was compensation?

A. Yes.

Q. Counsel on cross-examination asked you a series of questions about distinguishing between discretionary groups and association groups, talking about situations where an association—where the member might have some control over the organization.

A. Yes.

Q. Do you feel that in a large group like ABE the member has any effective control over the organization?

A. Yes.

MS. CARPENTER: Objection, no competence to answer that question.

THE REPORTER: Your Honor, I got the witness's answer at the same time as the objection.

THE COURT: I didn't hear the answer.

THE REPORTER: I had a yes answer, Your Honor.

MS. CARPENTER: Your Honor, forget it, the witness has a plane to catch. Let's get her out of here.

MR. DENNIS: I will strike the question from the record.

[2222] THE COURT: The answer must have come in the wrong way, Mr. Dennis.

THE WITNESS: I think so.

BY MR. DENNIS:

Does the member of the ABE in purchasing insurance need something from the ABE?

A. Need something? What do you mean?

Q. Well, counsel asked you a question attempting to distinguish association insurance from credit insurance where on credit insurance the member needs something from the creditor, the insurance, whereas is that true of association insurance?

A. Well, it is not quite the same thing. A member of the association is not quite at the mercy of the association as a borrower would be when faced by a stern banker who doesn't want to lend him anything.

Nevertheless the mere fact that the member is buying from the association assures they have a need to have access to association coverage.

Q. In the NAIC Bill you stated that benefits must be reasonable in relation to the premium charged; is that correct?

A. In the discretionary group, yes.

\* \* \* \* \*

[2305] Whereupon—

RUSSELL L. SIDERS

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. DENNIS:

Q. Would you state your name, please?

A. Russell L. Siders.

Q. And your address?

A. 346 South 124th Street, Omaha, Nebraska.

Q. Who are you employed by?

A. Mutual of Omaha Insurance Company.

Q. What is your current position?

A. Vice-President in the group operation.

Q. Is that the True Group Operation?

A. It is not called that, it is just called the group operation.

Q. And it deals primarily with employer groups?

A. Well, that is one of the products of group operation, yes. It would include pensions, group health insurance, life insurance, et cetera.

\* \* \* \* \*

[2383] Q. I think you say that logically "we would not want to increase premiums over the 85 cents mark as—

MS. CARPENTER: Excuse me. The witness did not say that. Mr. Breiner said that.

THE WITNESS: Yes.

BY MR. DENNIS:

Q. But you would agree with that statement?

A. Well, I would agree that you wouldn't want to price yourself out of the market. If that was the determination in going above 85, would do that, I would say logically you would not want to do that, no. Not that you didn't have to.

Q. So in pricing a product you would not attempt—for the ABE product you would not attempt to get the rock bottom price but you would still want to remain in the market range; is that correct?

A. I guess on a reading—well, yes, I would say that is a logical approach. I would say the rate isn't necessarily determined by the insurance company. We make a study, we make recommendations, we make suggestions and then the board makes the determination as to what they want the rate to be.

\* \* \* \* \*

[2413] MR. DENNIS: Mr. Barnhart is our next witness, Your Honor.

THE COURT: Call Mr. Barnhart.  
Whereupon—

E. PAUL BARNHART

a witness, called for examination, having been first duly sworn, was examined and testified as follows:

# DIRECT EXAMINATION

BY MR. DENNIS:

Q. State your name, please?

A. E. Paul Barnhart.

Q. And your age?

A. I am 57.

Q. Mr. Barnhart, I have asked that you prepare a summary of your professional experience for the Court.\* \* \*

\* \* \* \* \*

[2495] Q. Do the brochures set forth the statement about what the Endowment is going to use the funds for, the dividends for?

A. Yes, in general. The literature describes the purposes and activities of the Endowment, and the fact that any dividends returned to the Endowment will be used for these exempt purposes, primarily research and scholarships.

Q. And you are aware of the fact that notices are sent to members advising them about the level of dividends?

A. Yes, I am.

Q. Can you describe the level of dividends on the American Bar Endowment program?

A. In terms of their magnitude?

Q. Yes.

A. The general magnitude of those, yes. On three of the programs the dividends tend to be quite substantial, running in the general range of 30 to 50 percent or more. On the life program, the disability program and the hospital, in-hospital program, which is called the ESP program.

On the other two, the average performance in terms of returning dividends has been much less.\* \* \*

\* \* \* \* \*

[2520] Q. Could you state for the Court what those opinions are?

A. *First of all I find all five of the programs to be definitely competitive.* The life program, the major medical program and the disability program the most so. In the analysis I made I generally rank those three to be in the lower third of the general competitive marketplace in which they are offered.

The in-hospital program, the ESP program and the ADD-250 program are priced at a more average level. I would say I place them in the middle third, they about in general fall in the middle third of the marketplace in which I see those plans being offered.

So I deem them all to be competitive as to benefits and price with the life, the disability, and the major medical being the most relatively most competitively priced.

Q. Was the analysis that you made similar to the same type of analysis that you would make for an association that you consult with, or an insurance carrier concerning the credit card or mass-market insurance?

\* \* \* \*

[2546] A. \* \* \* If anything, had accidental death been available it probably would have been at a higher premium than used here for the adjustment.

Then the Ohio plan operates on a basis where it gives the member the option of either crediting his dividend against the next year's premium or donating it to the Ohio State Bar Foundation. The members are given an option of which of two ways they can apply their dividend.

Then the Oklahoma rates here also show net rates, they show the gross rate and also the net rate. And effective in 1977, and as near as I can determine from the information available that had continued to be in effect, that a 25 percent dividend was credited to the next year's premium. So again the gross rate shown is the going-in rate to a new member and the second year he would pay a rate discounted 25 percent as a renewal premium.

Then taking up the same matter on Exhibit 3, here the waiver of premium was included in these credit card plans that are shown here. Also this Airline Passenger Association plan. \* \* \*

\* \* \* \*

[2579] A. \* \* \* So it is quite clear that not only in theory but in actual fact the Bar Endowment has been at risk, and there are these two examples of administrative and marketing expenses not being covered by the dividend paid. And because of this the fact that the Bar Endowment's gross dividend return is very much at risk up front, the Bar Endowment is actually functioning here as the insurer and the insurance companies are actually functioning as reinsurers. Their role is exactly the same as the role of a reinsurer providing stop loss coverage under, say, something like an individually insured plan written by a commercial insurance company. The commercial company takes the up front loss up to a certain point and when the stop loss threshold is reached the reinsurer begins to assume the risk and that is exactly the role that is in fact being played by New York Life and Mutual of Omaha here. They are actually functioning as reinsurers, whereas the Bar Endowment is functioning as the insurer, as the primary insurer.

\* \* \* \*

[2610] A. That is now with John Hancock, I believe. I am no longer working with the American Optometric Association. They were insured with New York Life during the time I was their consultant.

Q. Both large mutual companies?

A. Yes.

Q. And a lot of large professional associations tend towards the large mutual companies; is that correct?

A. Quite a number, yes.



Q. And the dividends payable by John Hancock or New York Life either would be used for stabilization reserves or to reduce the premiums of the members?

A. Largely. There is also an expense allowance paid to the AOA. I am not clear on what—I don't recall exactly what that was, but I think in the nature of five to seven percent. I believe. And it differed on the life program as compared to the other programs.

Q. And they perform services in connection with the administration of the program?

A. Yes. Yes, that was to reimburse the AOA for various administrative services provided.

Q. The American Psychiatric Association, who underwrites that plans?

[2611] A. That is underwritten by Mutual of New York.

Q. And dividends are handled how?

A. Dividends are handled again in the same way, they are—well, here again there is an expense allowance, although it is very small, paid to the APA. And beyond that dividends that are declared are used to reduce members' renewal premiums.

Q. Expense allowance is for the services provided by APA?

A. Yes, directly in connection with the member insurance programs.

Q. Health Insurance Association of America is a trade association?

A. That is a trade association, yes.

Q. I was not sure what Illinois Health Improvement Association is?

A. It is an interesting and rather unique organization. It is what I would call a consumers' association. What it is composed of primarily are farmers and rural businessmen, small town businessmen. It is kind of an out of state

Illinois consumers' association. It has been in existence since 1948. It has been there a long time. And it has life insurance and health insurance in force. \* \* \*

\* \* \* \* \*

[2617] Q. Do I understand correctly that Exhibit 1410—I only have one copy—summarizes the list of documents and sources that you relied on, at least principally if I understand your testimony?

A. Yes, the principal sources of information that I actually ended up making use of.

Q. You stated an opinion yesterday that dividends and experience credits received by the Endowment constituted compensation; is that correct?

A. Yes.

Q. What have you read to give you any background concerning the history of the Endowment's insurance program?

A. Well, I have read I think primarily stipulation records that give a summary of the history of the Bar Endowment program.

Q. You read the stipulations filed by the parties; is that correct?

A. That is correct. And in the course of going through documents a number of memoranda, reports, [2618] minutes of committee meetings, and things of that nature.

Q. Did you make any systematic attempt to investigate the origin of the program in terms of its purpose?

A. Yes, I am familiar with that at least in a general way.

Q. Why don't you take out Exhibit 1410 and direct me to anything that you said you principally relied upon in that document that would help you understand the history and purpose of the program?

A. Well, I have not relied on the history and purpose of the Endowment program itself in forming my opinions on a case.

Q. So you formed your opinion as to compensation without relying upon the history and purpose of the Endowment programs?

A. That is correct.

Q. And you formed your opinion as to compensation without reviewing the testimony of Mr. Ron Foulis and the exhibits introduced in connection with his testimony; is that correct?

A. That is correct.

Q. And you formed your opinion on compensation without any systematic attempt to determine what the [2619] Bar has told its members over the last 28 years about the program; is that correct?

A. That is correct, sir. I don't believe what the Bar has told its members necessarily has any relevance to what in fact constitutes compensation.

Q. So whatever the Bar might tell its members, or indeed whatever the members might tell the Bar would have no relevance to your views on compensation?

A. In this case, that is correct.

Q. And if they held a meeting every year to which every lawyer came, where the entire purpose of the program was explained, and if an opportunity were given at that meeting to change the purpose of the program, and when the opportunity was presented every member of the American Bar Endowment got up and walked out, you couldn't care less in terms of your opinion on compensation in this program; is that correct?

A. Yes, that is correct, because I don't think that changes the facts relating to what retention of those dividends amounts to.

Q. Mr. Barnhart, what do you know about the facts in terms of the relationship of the American Bar Endowment to its members? You made no attempt to find that out, have you?

A. Oh, I think I have. I have read quite a few [2620] documents and reports, memoranda, quite a bit of information on that.

Q. Did you read the testimony of Mr. Reece Smith?

A. I have not.

Q. You have no idea what he testified to, do you?

A. No, sir.

Q. You have no idea about how the American Bar Endowment is governed, do you?

A. No, I don't.

Q. And you have no idea about how issues are raised at the American Bar Endowment meetings, do you?

A. No.

Q. And you couldn't know less about their procedures, could you?

A. No.

Q. And you have no idea whether in fact for all you know the subject of the insurance program could have come up every year for a vote, isn't that right?

A. It would be possible. I wouldn't know whether it had or not.

Q. And you just don't care what each side told each other in this insurance relationship; is that correct?

[2621] A. Well, I wouldn't say I don't care. But I wouldn't consider it relevant to my judgment as to the nature of the retention of the dividends by the Bar Endowment.

Q. You think you might have been able to make an opinion as to relevancy to your judgment on a better informed basis if you had made an effort to find out?

A. No, I really don't, because I don't believe I could have learned anything that would have made any change in my opinion. I think it would be very, very unlikely that that could be true.

Q. I think you are right.

Mr. Barnhart, we went over the four associations that you list on your resume in terms of providing advice and their association group plans. They are all big; is that right?

A. Yes. The American Optometric Association is perhaps the smallest, about 20,000 members. But the others are all quite large associations. Well, no, excuse me. The orthodontists would be the smallest, they have about 9,000 members.

Q. And these associations are in a position on behalf of their members to negotiate favorable terms and conditions with insurance companies?

[2622] A. Well, I wouldn't say the orthodontists or optometrists are really in that position. Because in obtaining the bids we found out that they didn't appear to be as attractive as we had supposed. We didn't get as many bids as we would have liked.

Q. What about the American Medical Association and the psychiatrists?

A. I think both of those would be considered very attractive association cases by most companies.

Q. Attractive associations that for various reasons could end up commanding low net cost for the benefit of their members; is that correct?

A. Particularly the American Medical Association, which has about I think 240,000 members, yes. It is mainly a matter of size. Size and prestige. Those two factors tend to predominate in the thinking of the carriers as to how much they would like to have the organization insured with them.

Q. How about the third-party administrators? Are they interested in organizations of size and prestige?

A. Yes, I think equally so. Yes.

\* \* \* \* \*

[2627] Q. Well, there is certainly no doubt in your mind that the ABE rates are an overcharge compared to what this association could negotiate if they, if the association, determined to run a service insurance plan for members; is that correct?

A. The association could at least on the three programs generating larger dividends, could be charging lower premiums.

Q. Tell me what the cumulative percentage dividends has been on the accidental death dismemberment — ADD-250 program for ABE?

A. I couldn't give you the cumulative. In percentage form?

Q. Yes.

A. I couldn't give you the cumulative, though I would judge it to be probably in the area of 40-50 percent. But I could not give you that.

Q. Cumulative dividend is 40 to 50 percent? Do you know what the dividend was last year?

A. 1982?

Q. Yes, sir.

A. No, sir.

[2628] Q. Well, there is testimony in the record that it was 53 percent. Do you know what the estimated dividend is this year?

A. I do not.

Q. There is testimony in the record that it is in the 90 percentile.

A. It is a dividend that will fluctuate dramatically from year to year because three or four claims would equal the annual premium income. One of the years in suit here I think there were no claims. The loss ratio was virtually nil. So the experience can range all the way from no claims to several, and three or four claims would wipe out the premium on that program.



Q. As an actuary would you agree with my suggestion that it is a volatile program?

A. Indeed I would, yes.

Q. As a volatile program doesn't it make more sense to look at the return on that program over a period of time longer than one year?

A. Oh, yes. Absolutely.

Q. So you would agree with me that with an experience to date through 1981 of 40 percent and 53 percent in 1982 and 90 percent or so in 1983, there has indeed been a substantial return on that program?

[2629] A. Over that period, yes. Again I would say three years is too short. You would want to look at that program over about 15 years.

Q. So far the program—I believe the program started in 1976, so it is in existence for maybe seven years?

A. Yes.

Q. What about the major medical, do you know what the cumulative return has been there?

A. No, sir. Not on the cumulative basis. But I would guesstimate at perhaps 20 percent.

Q. You didn't make any effort to determine that in terms of expressing your opinions in this case, did you?

A. No, I looked at the experience over the three years in suit here.

Q. And didn't look at it before then or after then?

A. I saw the results for the period before then. And during the first four or five years it generated pretty substantial dividends in the early—first three or four years it was in force.

Q. In the preparation of Exhibit 1336, did anybody tell you what companies to include or what not to include?

[2646] \* \* \* \*

A. In general. But it is impossible to know the rates and the exact position of every one of hundreds of companies.

Q. Do you make it your business to know the lowest rate companies?

A. To be aware of some of the low rate competitive companies, of which Occidental Life has always been a notable example.

Q. You don't know Kemperer's position?

A. Not specifically, no.

Q. Let me direct your attention specifically to the exhibits. Do you use male rates only for convenience?

A. Not for convenience. But because male rates would generally be the appropriate rates to compare. Most of the members would be males.

Q. What percentage of the members of the American Bar Endowment are males?

A. I don't know exactly. But I would expect it certainly must exceed 80 percent. In most professional societies it is over 90 percent.

Q. You don't know what the bar is?

A. I don't know the specific demographics.

Q. Last five years, do you know how many people [2647] graduating from law school were women?

A. No, sir, I don't.

Q. Is it fair to say irrespective of how many members of the bar are women, that Exhibit 1 here doesn't fairly reflect what women could get life insurance at?

A. That is correct, it does not really show women's costs.

Q. What are the standard rates? Why did you pick standard?

A. Standard because those I think would be the best representative rates for most of the members, for the majority of the ABA members.

Q. I noted that you footnote the fact ABE accepts applicants up to 250 percent of New York Life's standard mortality. Why did you do that?

A. That is to point out the fact that ABA members can get into the Bar Endowment program at a substandard

level at which they could not get into most of these other standard plans on the market.

In other words, the ABE underwriting is more liberal in that respect, and which adds to its value.

Q. New York Life's underwriting is more liberal?

A. New York Life's, yes.

Q. All right. Am I not correct that [2648] approximately 90 percent of the life insurance that is underwritten in this country is issued standard?

A. I would say 80 to 90. I am not sure as high as 90.

Q. Am I not correct that approximately 5 percent of the people in the country are uninsurable, at least in the eyes of the insurance industry?

A. That is a pretty reasonable estimate, yes.

Q. And then taking either your percentage or mine, 5-10 percent maybe are rated; is that correct?

A. My experience has been that probably around 10, between 10 and 15 percent get rated on some basis.

Q. What percentage of the population is eligible for preferred rates?

A. I wouldn't be sure about that, but I would judge it is probably in the area of 20 percent maybe.

Q. Okay, so we have 20 percent of the population eligible for preferred rates, something less than that gaining the benefit, as I understand your testimony, of the New York Life underwriting, but your exhibit refers only to the fact that some people who are on standard can get into the ABE plan, it doesn't say a word about the fact that maybe 20 percent or more of the lawyers would be eligible for rates cheaper than standard rate? Isn't that fair?

[2649] A. Well, that is fair, but you also have the proportion going the other way. I think the appropriate comparison is to use standard rates here, that would cover the majority.

Q. My only point and maybe it is not that much of a point is that you footnote it one way and didn't footnote the other way.

Let me direct your attention specifically to the American Bar Endowment column and the 50 and over figure, \$1375. Am I not correct that the rate for a lawyer 55 to 59 if you had bothered to interpolate out would be \$1833, not 1375?

A. Yes, it would continue to rise on a per \$100,000 basis.

Q. You didn't bother putting that on this table?

A. No, I didn't think that was that pertinent. This was not meant to be a precise analysis but only to place the general competitive position of the bar program. It is not necessary to be completely precise and detailed in order to establish a general competitive comparison.

Q. And it was not necessary to put in the higher rate, right?

A. Not necessary to put in rates at higher ages.

Q. Let me see if I understand something about [2650] waiver of premium and accidental death dismemberment.

Do I read your footnotes correctly to say that the plans other than ABE don't contain those provisions or benefits but you made mathematical or dollar adjustments to include them?

A. Are you referring to Exhibit 1 still?

Q. Yes, Exhibit 1.

A. WP and AD can be purchased with those plans. The rates shown in the Life Rates and Data addition show the rate for just the basic life but WP and AD can be purchased.

Q. And you adjusted those plans to include those benefits?

A. To include those benefits, yes.

Q. Let me ask you about the New York Life column. What dividends was [sic] illustrated on the policy referred to in that column?

A. I don't recall, Mr. Gregory. It wouldn't be simply a dividend, but rather a net cost projection, probably a 20 year net cost projection.

Q. Am I not correct there was indeed a net cost projection illustrated and that illustration is is [sic] not reflected on this table?

A. That illustration is not reflected here, that is correct.

[2651] Q. Am I not correct that in 1980 the New York rates for term life were in fact behind the rest of the industry, behind in the sense of not as low as the rest of the industry?

A. I don't know about that, whether they would really be judged as behind or even or just where. It is a very fluid business, of course, as to who is lowering rates or adjusting rates first and second and third and I don't know where I would try to put New York Life in that spectrum.

Q. Do you know what happened to the New York Life rates in 1981, 1982, 1983?

A. I believe they have been reduced.

Q. About 40 percent?

A. I don't know the magnitude, but I am quite sure they have been reduced.

Q. Let me make sure I understand one other thing. I am referring to the columns other than ABE on Exhibit 1. Am I not correct that what is illustrated is annual renewable term insurance at guaranteed rates?

A. All of these non-participating programs are at guaranteed rates, yes. Also the New York Life rates on a gross basis are guaranteed.

Q. And the bar plan's rates are not; is that [2652] correct?

A. The bar plan's rates are not guaranteed.

Q. Let me ask you to turn to Exhibit 2. Do I understand your criteria of selection to be large states with large members of the bar?

A. Yes, along with the fact of finding other associations that wrote amounts of insurance up to the general

level of what was available under the bar. And plans that were reasonably comparable in that sense as well as larger states.

Q. We established this morning you did not include California because you didn't have the information available and did not bother to get it; is that correct?

A. That is correct.

Q. Were you here for the testimony of Ms. Khachadour?

A. No, Sir, I was not.

Q. Do you know the Government brought her from California to testify?

A. I did know that.

Q. Do you know she testified about the California State Bar insurance plan?

A. I don't know what she testified about. I didn't hear it.

[2653] Q. Why didn't you include the Michigan Bar?

A. I don't recall exactly, Mr. Gregory. I looked at the Michigan Bar and I at the moment can't recall why I felt it was not a good example to include. There was something about that program that didn't seem as though it made a ready comparison but I don't recall what it was.

Q. Rather a large state with a lot of lawyers?

A. It is a pretty large state, yes.

Q. So is New Jersey, isn't it?

A. Yes.

Q. So is Illinois, isn't it?

A. Yes. These are here as illustrations, Mr. Gregory. My conclusion or opinion doesn't simply depend on this analysis. This is illustrative.

Q. We will get to your conclusion.

A. All right.

Q. And Florida doesn't appear, does it?

A. No, sir.

Q. And the L. A. County Bar doesn't appear, does it?



A. No. I didn't try to use any city or county bar plans; just used state bar plans.

Q. Do you know if there are more lawyers in Oklahoma or Los Angeles County?

[2654] A. I expect more in Los Angeles County.

Q. Didn't use the District of Columbia bar, did you?

A. No, I did not.

Q. We can all agree there are too many lawyers in Washington, right?

A. (No response)

Q. I don't see the Pennsylvania bar around. It is not on either?

A. No, not here.

Q. And you did not pick the Missouri bar, your home state?

A. No.

Q. And there has been testimony in this case about the Missouri bar plan, are you aware?

A. Yes, I am aware. I heard Mr. Gardner testify about that.

Q. And you were here when he testified about the Missouri bar?

A. Yes.

Q. And about dividends going back to the members?

A. Yes.

Q. Low net cost insurance?

A. Yes.

[2655] Q. Directing your attention to column 1 again on ABE, —in fact let me see if I understand what is going on here. What is the 55 to 59 in the second column right under where it says exhibit?

A. That is the age bracket.

Q. And across this column you are illustrating rates for age 55 to 59?

A. Yes, showing the rate up to that point.

Q. But not for the ABE?

A. No, the benefits begin to grade at age 55.

Q. And you did not determine what the cost per thousand was at age 55 through 59 which is \$1833, did you?

A. No, I did not.

Q. Let me ask you to look at the Georgia Bar column. If you had put in the 55 to 59 age, am I not correct that the net dollar cost for the Georgia Bar was less than the gross premium charged by the ABE at every age?

A. Less than the gross premium charged for the ABE at every age? The net cost you say for 55-59?

Q. No, the net cost for each age for the Georgia Bar. Is it not correct that that net cost is lower than the gross premium cost at the ABE for every age, assuming you had bothered to put in the 55 to 59 [2656] figures for the ABE?

A. I believe that would probably be true. I would have to check the costs — you mean comparing to the gross ABE premium?

Q. Why don't we just take an example. Perhaps I am not being clear. Under 30, ABE gross premium, \$200, right?

A. You are referring to the ABE gross premium then?

Q. That is correct.

A. That is the clarification I was asking.

Q. And am I not correct that the appropriate comparison for the Georgia Bar is 132?

A. Yes. Yes.

Q. Well, my question — and looking at the exhibit, if you have not determined it already — I am asking you am I not correct if you made a similar comparison at each age the Georgia Bar is materially cheaper?

A. It would be lower.

Q. And if the ABE is in the bottom third of rates how far down would you look to find the Georgia Bar?

A. I would say it is probably in the lower 20 percent.

[2657] Q. What is the universe of one that you are comparing these rates to in terms of lower one-third? Lower one-third of what?

A. The totality of the types of insurance represented on the three exhibits. In other words, state bar plans, individual term rates, mass-marketed, credit card; all of the range of competitive products that are in this marketplace available to attorneys.

Q. How does the ABE insurance compare under that standard on Exhibit 2? That is, ABE versus state bars?

A. Here it would compare a little above 50 percent. It would be in the upper half.

Q. Well, it certainly is above Georgia at every age level; is that correct?

A. That is correct.

Q. Let's take a look at Massachusetts. What does bonus mean at the top of that column?

A. In 1981 they declared a dividend in the form of an additional 50 percent, I believe it was an additional 50 percent over the regular amount but available at the regular rate. And this takes account of that, this reduces the rate per hundred thousand based on the bonus amount of coverage available.

In other words, they would have gotten [2658] \$150,000 of insurance at the same rate as they would have paid for a hundred thousand, and this recalculates the rate per hundred thousand on that basis.

Q. What refunds—excuse me, what are refunds done—strike that, please.

Should this be NEBA, by the way?

A. It should be NEBA.

Q. That is a trust?

A. Yes.

Q. What does the trust do with the refunds that are assigned to it?

A. I do not know.

Q. And you don't know whether it goes back to the members or not, do you?

A. I have not examined what the trust itself does with those refunds.

Q. So if indeed it does go back to the members that is not reflected in your calculations?

A. Not to the extent there might be any additional cash dividends paid. The bonus itself is in the nature of refund. This is one way of providing a refund is to give a bonus in coverage as distinguished from a reduction in premium.

Q. Did you determine in the course of your [2659] analysis how the Massachusetts rates compared at various ages with ABE?

A. As far as the chart is carried, yes, to the end of the low 50s.

Q. At what rates is the—what age is the bar higher, what age is the bar lower than Massachusetts?

A. The bar rates become lower at age 35, and I believe remain lower above age—starting with age 35.

Q. Let's take a look at Minnesota. I am looking now at the bottom of the first column. That indicates substantial dividends on the first 80,000 of insurance, is that not correct?

A. Yes, it does.

Q. That is not reflected in your rates, is it?

A. No, because I only actually reflected in that, rates under these calculations where the amount is definite. Where it is clearly determinable.

Q. Wait a minute. 49 percent of something was determined in 1977, wasn't it?

A. In 1977, yes.

Q. And 1978 was 56 percent?

A. That is correct.

Q. And 1979 was 60 percent?

A. Well, but those were after the fact. Those are determinations after the fact. I brought in net [2660] cost calculations here wherever that is known to the member at the time he would buy the coverage. That was the criterion followed here.

Q. You think the Minnesota Bar told people that they received these significant dividends?

A. I am sure they did.

Q. And you certainly are sure that it impacted their store of knowledge about that program, aren't you?

A. Yes, I would certainly expect so.

Q. And if you had put anything for dividends in the calculations for the Minnesota Bar, those bar rates would have been lower at all ages by far than ABE?

A. They would have been lower, yes.

Q. Let's look at Texas. Do you know what happened in 1981, in Texas, with the Texas Bar?

A. No, sir, I don't.

Q. Am I not correct that the Texas Bar rates illustrated are lower at every age than the American Bar Association rates?

A. Yes, they are.

Q. You have no idea how the Texas Bar handled its insurance situation in 1981?

A. No, sir, I don't.

[2661] Q. Who underwrites the Texas Bar?

A. At this time it would have been Prudential Insurance. These are Prudential rates.

Q. And Prudential Insurance began underwriting in 1981; is that correct?

A. I believe that is correct, but I was not certain about that.

Q. Let's take a look at the Indiana Bar. On your illustrations, am I not correct that the Indiana Bar provides lower insurance to members than the ABE at all ages except age 55?

A. Yes, I believe that would be correct.

Q. And if you had done the calculations for ABE at 55 it would have been within a hundred dollars?

A. Would have been close, yes.

Q. How did you account for the experience premium reductions in Indiana in computing your rates?

A. I did not take them into account because I had no information on what those might have been.

Q. Did you bother calling the Indiana Bar to find out?

A. No, sir, I did not.

Q. Don't you think you should have?

Q. No, sir. As I mentioned, these are illustrations here. All we are talking about is a [2662] spectrum of broad price competition, competitive rates over a marketplace spectrum. And the kind of precision you are suggesting is needed here is simply not necessary to this kind of analysis.

Q. Let's look at the Indiana Bar. Why don't we just pick age 45 to 49. 632.00. Is that a broad spectrum, a broad range or is that a precise figure?

A. That is a precise example.

Q. And if you had call the Indiana Bar with respect to 1981, you could well have found out the actual net cost to the member was lower than that, right?

A. Probably so, yes.

Q. But you did not bother?

A. No, sir.

Q. Let's turn to New York. What did you do with the accidental death and ADD-250, or ADD portion of the New York State Bar; how did you compute that?

A. That has been added into the rate at the \$72 per hundred thousand basis.

Q. And how did you account for that in adjusting the dividend?



A. That is not accounted for because the dividend was 45 percent of the life premium. There has been no adjustment made here up or down for the [2663] accidental death.

Q. Is it not a fact, sir, that you added the \$72 to the New York rate and took no account of the fact that a substantial dividend increase would have occurred, if accidental death had been included in this particular plan?

A. It would not necessarily have been the case at all. They might or might not have any dividend.

Q. What was the cost of the American Bar Association accidental death components in the New York Life Insurance plan?

A. Which year?

Q. How about the year you were dealing with, 1980-1981?

A. 1981? In 1981 they had a — that was a year of a very large refund, about 97 percent. In 1980, it was zero.

Q. I am talking about the New York Life Insurance plan, Mr. Barnhart. I think that is what Exhibit 2 is about.

A. I thought you were talking about the accidental death.

Q. The accidental death component, yes. It is my understanding you are testifying that you put the component into the New York Life rates, upped the [2664] rates at \$72 for the New York State Bar; is that correct?

A. That is correct.

Q. And I am asking you, sir, is it not a fact that New York Life would have paid a dividend on that amount in 1981 if the full \$72 were not needed?

A. If the \$72 were not needed, yes.

Q. Is it not a fact, sir, that the experience on the ADD, was that the cost for the disability component — excuse me, I misspoke. The accidental death components was between 30 and \$32, not \$72?

A. On what basis?

Q. On actual experience basis on the American Bar Endowment plan at New York Life, in the 1980-1981 timeframe?

A. But not to the member, Mr. Gregory. Only to the Bar Endowment as group policyholder, not to the member.

Q. That is fine, New York State Bar people get the dividends back, isn't that correct, sir?

A. Yes, but we don't know, have no way of knowing what their dividend might have been had they included accidental death in this plan.

Q. Are you suggesting that if accidental death was included in this plan, the cost would have been [2665] closer to \$72 than to the 30 to \$32 experienced by the American Bar Association?

A. It might have been every nickel of the \$72 or it might have been 30 or 40 or 50.

Q. Or it might have been 20, 25 or 30?

A. Might have been 20, 25 or 30.

Q. And it is a participating plan; is that correct?

A. That is correct.

Q. And the money goes back to the members?

A. Yes.

Q. And you have been comparing New York State Bar to the ABE which has had a cost of 30 to \$32, not 72, and your rates on the New York State Bar column make no adjustment for the possibility of a dividend, correct?

A. No dividend on the accidental death.

Q. You just put it in at 72 and assumed there would be no dividend; is that correct?

A. I didn't assume anything about it, about a dividend. Simply that this was not a known quantity.

Q. And not one you made any effort to get any information on either?

A. Well, they didn't write it; there wouldn't have been any way to get information on it if they [2666] didn't write it.

Q. What about Ohio, how did you account for the dividend in the Ohio plan?

A. There again, because I had no information on what the dividend experience was, there is no account taken of any dividend.

Q. And again, you made no effort to get the information?

A. That is correct.

Q. Now I am correct on the New York column, the net column, that even with your method of putting in the gross only for the accidental component and not giving credit for dividend, that the New York bar plan is lower at every age?

A. Yes.

Q. And even without factoring in the dividend on the Ohio plan, it is lower at all ages but two?

A. Yes, sir, that is correct.

Q. How does Oklahoma get into this? How many lawyers are there in Oklahoma?

A. I don't know, but Oklahoma is one of the more substantial states.

Q. Mr. Barnhart, isn't it a fact that what Exhibit 2 demonstrates, based upon the companies that you have chosen, is that there was available in the [2667] years you have chosen to members of the American Bar Endowment substantially cheaper insurance from their state bar associations?

A. In many instances, yes.

Q. And the numbers are right here, correct, on Exhibit 2?

A. Yes.

Q. Except for the ones you did not bother to get.

A. (No response)

Q. Why didn't you include the L. A. County Bar?

A. As I mentioned, I was only using state bar plans. I did not really consider using any city or county bar subdivisions.

Q. You were given the brochures for L. A. County Bar by the Department of Justice, were you not?

A. I don't recall that particular one. I had the Philadelphia Bar and the D.C. Bar. I frankly don't recall seeing the L. A. County Bar. But I had a lot of them, so I might have had.

Q. Let me show you, it is marked as Defendant's Exhibit 2090.

THE COURT: Have we seen this one before, Mr. Gregory?

MR. GREGORY: No, I won't ask that it be [2668] introduced, but we have not seen this before. This was marked by Defendants who asked us to enter into a stipulation, I think, or something.

BY MR. GREGORY:

Q. I guess my first question has to be did the Department of Justice provide you with the L. A. Bar brochure?

A. I am honestly not sure. I don't recall seeing it, but there were so many there that it could well have been included.

Q. This is underwritten by Northwestern National; is that correct?

A. Yes, it is.

Q. And they underwrite a lot of bar plans, am I not correct?

A. I don't know about bar plans, but they are certainly active in the association group field.

Q. You will agree they are quite active in the association group field?

A. Yes, sir, they are.

Q. It is administered by Marsh & McClennen, a leading third-party administrator with whom you have dealt yourself; is that correct?

A. That is correct.

Q. My reading of the brochure, and I assure you [2669] it may be faulty so take the time you want, is that the plan includes accidental death and dismemberment as

well as waiver of premium. I believe that any dividends are credited to the participants.

All I want you to do is look at it, and see if you would not agree with my observation that the rates available to members of the L. A. County Bar are substantially less than the rates provided on your Exhibit 2 for the American Bar Association?

MR. DENNIS: Your Honor, I would just like to ask that the witness be given five minutes to review the document, five to ten minutes, because he has advised me it takes quite a bit of time to look through a brochure and determine whether it is comparable to the Endowment plan. So if we are going to be having the witness review a lot of state bar plans, perhaps counsel could give them to the witness so he could take time to review them rather than trying to rush him through his testimony.

MR. GREGORY: Let's put aside the suggestion, which I know was not intended, that I try to rush anybody through testimony. I have just three other brochures and just a few questions about them and I would be happy to give them to the witness.

Your Honor, yes, I think that is a good [2670] suggestion, we might take five minutes and enable me to finish quickly.

THE COURT: Well, I am at the mercy of counsel. I don't know how long it takes to review these things. If counsel tells me and the witness tells me, we will take the break. Do you think that would help you, Mr. Barnhart?

THE WITNESS: Well, I believe in this instance I have looked at it far enough to answer Mr. Gregory's questions on the life program, I believe.

MR. DENNIS: Fine.

THE COURT: Don't feel rushed.

THE WITNESS: It was all here, right here pretty readily locatable.

THE COURT: I remember L. A. County is pretty snappy in its brochures. If any time you have a problem in answering a question, just be sure to ask for more time.

THE WITNESS: I believe I can respond. Would you state the question you had on this, Mr. Gregory?

BY MR. GREGORY:

Q. Well, I will do better than that. I will put us out on a limb. Here is what I think the differences are; you tell me if I am right or wrong [2671] and then we will take talk about it.

(Document handed to witness by Counsel Gregory.)

THE COURT: You have been using your calculator again, Mr. Gregory?

MR. GREGORY: No, I have been using Ms. Carpenter again.

THE COURT: I know she offered me a calculator the other day. Completely lost my composure.

MR. GREGORY: There are a thousand things you want to keep me away from. One would be exhibits and the second would be math and calculators.

MS. CARPENTER: Would you like a calculator, Mr. Barnhart?

THE WITNESS: No, I am just multiplying by two in this case.

THE WITNESS: Your figures are correct, Mr. Gregory.

MR. GREGORY: We have a very erudite actuarial presentation, it says "us, them and difference." At ages 30 to 34, us is 250.

THE COURT: "Us" I take it is —

MR. GREGORY: American Bar Association. The good guys.

[2672] THE WITNESS: And I understand them to be Los Angeles County.

MR. GREGORY: 189 for L. A. for a difference of \$61. Ages 35 to 39, us \$375. L. A. County 252 for a difference of 123.



Ages 40 to 44, the Endowment, \$500. L. A. County 370. For a difference of 130.

45 to 49, L. A. County, \$875 — excuse me, the bar \$875, and L. A. County 552, for a difference of 323.

And ages 50 to 54, American Bar Association \$1375, L. A. County \$955, for a difference of \$420.

I think you could agree that the L. A. County Bar rates are lower at every age?

THE WITNESS: Yes, sir, they are.

BY MR. GREGORY:

Q. Substantially?

A. They are substantially lower, yes.

Q. Why did you not include the South Carolina Bar?

A. I might have passed them up as being a smaller state, again. I passed up a lot of states on the basis of being relatively low population states.

Q. South Carolina smaller than Oklahoma?

A. I think so, yes.

[2673] Q. In terms of lawyers?

A. I don't know. I was going just by state populations. I was assuming the ratio of lawyers to population is roughly —

Q. Dangerous assumption in D.C.

THE COURT: Or L. A. County.

MR. GREGORY: Or New York City.

(Document handed to witness by Counsel Gregory.)

BY MR. GREGORY:

Q. Now, this bar as well, and I will give you all the time you want, let me tell you my assumptions first. It is administered by Northwestern National again. It has guaranteed rates, accidental death and waiver of premium are included. The bar member can elect to purchase up to \$500,000 in insurance.

Now, I would like you to take an eye look at the rates, please? My only question is whether I am correct that the rates are lower at all ages for the members of the South Carolina Bar than for the American Bar Endowment.

MR. GREGORY: Let me say this is labeled Defendant's Exhibit 2087.

(The document referred to was marked Defendant's Exhibit No. 2087 for [2674] identification.)

THE WITNESS: Yes, sir, these again would be lower at all the age brackets.

BY MR. GREGORY:

Q. I think I can skip the couple more exhibits I had for you.

Am I not correct that if I took the time to do it, I could go on out and check the state bars and based upon your Exhibit 2 and other material furnished to you by the Department of Justice, isn't it absolutely correct that members of state bar associations had available to them insurance at rates substantially cheaper than offered to the American Bar Endowment?

A. Certainly not in every instance. Some — well, many states, yes, but not in every instance.

Q. The ones that you put on your chart and the ones I have shown you today?

A. Among these, by and large, yes.

Q. The numbers will speak for themselves on the chart, correct? Or the generalities would speak for themselves on the chart; is that right?

A. What generalities, sir?

Q. (No response)

Let's move on quickly and try to finish this. [2675] Take a look at your Exhibit 3, please. You state in your testimony here, sir, that the bias in your work was in favor of the American Bar Association because standard rates were used. That is just not correct, is it?

Based upon our discussion before, is it not correct that the bias is against the Endowment because it is more logical to expect that more ABE members are eligible for preferred rates than would have been underwritten adversely?

A. Well, more of them would have been eligible for preferred rates, but when an individual has to take a substandard rate the difference will generally be higher the other way. In other words, a smaller number of people rated substandard will account for more dollars of difference. I don't think you can properly assume that simply because more people will get preferred than get substandard, that the dollar effect of that is therefore in favor of the preferred.

Q. Were the policies on Exhibit 3 sold with waiver of premium and accidental death benefits?

A. By and large, these had a waiver of premium included. But the accidental death I added in again to make the rates equivalent.

Q. To the extent you added in the accidental [2676] death, then the policies illustrated on Exhibit 3 don't exist in the marketplace; is that correct?

A. In that sense they would not, that is correct.

Q. What percentage of individuals in the United States today qualify for non-smoker rates?

A. Among companies that offer that rate, which is an increasing number, it tends to run 60 to 70 percent qualify for the non-smoker discount.

Q. A lot more than get rated, right?

A. Yes, that is true. But again the percentage difference is much smaller. The tendency is for non-smoker discounts to run five or 10 percent most of the time.

Q. Let's look at Exhibit 4. Was this Exhibit completed on October 6, 1983?

A. I believe so. Yes.

Q. Do you have any idea why we didn't get it?

A. No, sir, I don't.

Q. This illustrates catastrophe major medical; is that correct?

A. Yes, or excess major medical as it is sometimes called.

Q. Do I see two question marks under the ABE column on this exhibit?

[2677] A. Yes, the years, which I verified after testifying yesterday, those are correct. Those were the rates in effect in that year, in the year 1977 and also in the year 1979.

Q. How does your chart give effect to the rate increases in 1979 and 1980 for the major medical plan of ABE?

A. These show the rate increase that took effect in 1979. And that is that increased rate.

Q. I see here in the other columns Georgia, '82, Minnesota '80, Illinois '80, Indiana '80, Ohio '81 and Virginia '81; is that correct?

A. That is correct. Yes, sir.

Q. And under ABE, you did not take into account any increase in 1981, did you?

A. No, sir, I didn't carry it that far. There was an increase, I believe, in September of 1980. And an increase in 1981 also.

Q. Just quickly on Exhibit 5, am I correct that the column for the New York Bar does not illustrate a 28 percent reduction for the experience rating?

A. No, sir, those are the gross rates.

Q. So I am correct that it does not illustrate the experience rating?

A. That is correct, it only notes that it was [2678] averaging about 28 percent at that time.

Q. Do you find it customary in the group insurance business to talk about expected loss ratios in a range of 70 percent?

A. Yes, sir, particularly association group. That is a pretty normal or pretty customary expected loss ratio for rates to be established at.

Q. Was that before or after retrospective credits?

A. That is before. That is a gross rate determination.

Q. Well, I am finished with this exhibit. Now just a couple more areas and we will be done.

I want to turn to the subject of risk, Mr. Barnhart. As a participating policyholder of the Northwestern Mutual Life, do I bear an insurance risk?

A. Only a very slight and remote risk as an individual, because you would be pooled with tens or scores of thousands of other persons. You would have a very small share of that.

Q. And each of the individuals in my class, and that is what we refer to as pooling for purposes of distribution of divisible surplus, my class?

A. Yes, determined on a class basis.

\* \* \* \*

[2681] Q. You tell me why it doesn't?

A. Well, the Bar Endowment is subject to the aggregate risk of its particular membership. So any fluctuations that occur, immediately impact directly on the bar. Now, to the extent each member would get a pro rata share of this, is that were those dividends returned, then each member would bear the same—his same small percentage share in that proportion. But the member does not have expenses, for example. He doesn't have any expenses at risk in the sense of the Bar Endowment must also cover its expenses.

Q. I thought we were talking about insurance risk. We will get to insurance expenses. You testified yesterday, if I understood you, that the Endowment functions as an insurer and that New York Life is a reinsurer because it is a participating policy and the dividends might be reduced to zero. And I am suggesting to you that that is no different than any other large professional association such as the ones you represent who return the dividends to the members; no different in terms of the mortality-morbidity risk. Is that fair?

A. Yes, that would be true in the aggregate. Yes.

Q. So then the people you represent function as [2682] insurance companies?

A. You mean the association groups I work with? Not the association.

Q. Yes; have you told them they are insurance companies and that Mutual of New York or New England Mutual is a reinsurer?

A. Well, the dividends there take the form of renewal premium reduction to the members so the dividend gets passed on to the individual member. You could look at each member as bearing his tiny share of that risk.

Q. As a tiny little insurance company?

A. In a sense he is self-insuring a small portion of that total risk, yes.

Q. Have you ever told any one of the associations you represent, or any one of the tens of hundreds of those members of those associations, that any one of them or all of them has functioned as an insurance company?

A. No, not on the individual basis.

Q. Have you ever told any one of them that they are not involved in a group insurance program?

A. No, I don't believe I have ever said they are not involved.

Q. But you say the Endowment is not group [2683] insurance, it is individual insurance?

A. Yes. That is correct.

Q. Have you advised the members of your association to strike the phrase group insurance from their brochures?

A. No.

Q. Have you told them not to represent to the members that these are group insurance rates?

A. No. These are group insurance rates. The rates are a group rate.

Q. Oh, well yesterday you said the benefits were similar to group insurance, and now today we can agree that the rates are group insurance rates? Is that correct?

A. Yes, the rates are group rates.



Q. And I am sure now we can also agree that the existence of the experience refund or the dividend is more akin to the group insurance, as you understand it, than it is to individual insurance?

A. Oh, yes, which I testified to yesterday. The dividend, itself, is a group type experience rating.

Q. Well, today we can agree then at least as to the comparison between group and individual that the Endowment can be compared to group as to rates, [2684] benefits, and experience refunds, correct?

A. Yes.

Q. Just like all the other associations you represent. Mr. Barnhart, you have never told anybody, suggested or testified that association group insurance is not group before your testimony in this case, isn't that correct?

A. Because that distinction, Mr. Gregory, was not pertinent in those cases. Here the question of whether the insurance involved is more like individual or more like group would appear to be a relevant question. There I don't think it is a relevant question.

Q. Can you cite me one example of a professional association group, a legitimate association that you know of that receives and retains dividends of the size of the Endowment?

A. I would not know of any receiving dividends in that magnitude, no.

Q. And certainly none of your associations do? The ones that you advise?

A. You mean in which the association retains the dividends?

Q. Yes.

A. No, none of them do, they all pass it on [2685] through in premium renewal discounts to the members.

Q. Did I understand you to testify yesterday that the Endowment had a—something about significant share of the market.

A. Yes.

Q. What were you saying?

A. I was saying a share of its market. Its market is the membership of the American Bar Endowment. And, for example, under the life program there are about 40 thousand, roughly 40 thousand members insured, which is approximately I believe 20 percent of the membership. I believe the ABA membership is about 200 thousand.

Q. In what year was the ABI membership 200 thousand?

A. I would have estimated it at that, at about this time, around 1979 or 1980.

Q. What is the basis for your estimate?

A. I think it was some of the numbers I looked at in that Moran study, the New York Life study.

Q. You didn't read any testimony from ABA representatives?

A. I don't believe so, no. No.

\* \* \* \* \*

[2689] Q. So what you are telling me is that the members of the American Bar Association who have been elected by their peers as officers identified themselves as a good submarket upon which to profit at their own expense?

A. I am not suggesting some deliberate selecting of a market but only that this is the submarket that they in fact deal with.

Q. Did I hear your testimony incorrectly yesterday, did you not say yesterday that they identified a good submarket?

A. Yes, I used that term.

Q. Would you explain to me where the profit on the American Bar Association Plan comes from?

A. The profit basically comes from the favorable mortality and morbidity exhibited by the membership.

Q. "Favorable mortality and morbidity exhibited by the membership."

A. That is correct. And that in relation to the price that is being charged for the program.

Q. And who sets the price?

A. The price would be negotiated between the Bar Endowment representatives and the insurers.

Q. And the Bar Endowment representatives are [2690] the elected members of the Endowment? Are elected by the members of the Endowment?

A. I presume that they are, I don't know just how those officers are selected.

Q. What services does the Endowment perform from which they generate the five to seven million dollars of profit alleged in this case each year?

A. Well, they first perform the service of negotiating a program to be available to their members, making that program available to the insurers. I think this is a significant function that they perform, making a market, a special market available to the insured. They market the program, prepare the literature, market the program, solicit enrollment, receive and process applications, do a certain amount of preliminary underwriting or prescreening on those applications, they bill and collect the premiums, receive the premiums, remit them to the carrier.

They also, as I understand it, receive the claim reports and do a certain amount of preliminary screening of claims mainly just to see that the claim report is complete. And at that point the claims are transmitted onto the insurers for actual payment.

Q. What service have you identified to me in that recitation that is not performed by each and [2691] every association you represent either singularly or in concert with a third-party administrator?

A. I believe the association and the third-party administrator in combination in all the ones I work with would perform pretty much that same range of services.

Q. And you can't identify for me another professional association in the United States that makes profit to the extent of the Endowment from performing these services, can you?

A. Not to that extent, no.

Q. Ms. Khachadour, formerly of the California Insurance Department, said that the level of profits made by the Endowment would make her choke.

As an advisor to professional associations and their members wouldn't you choke if an association were profiting to the extent—profiting to the extent of 50 percent of premiums on its own members?

A. I would certainly not be very happy about that.

Q. And you certainly wouldn't be happy if you were a member, would you?

A. No, I would not.

Q. You would do whatever you could to get your association to change that horrible state of affairs, [2692] wouldn't you?

MR. DENNIS: Your Honor, he is not testifying as a member of the association, he is testifying as an expert actuary in this case.

BY MR. GREGORY:

Q. You are a fellow in the Society of Actuaries?

A. Yes.

Q. As president—you were president of the Society of Actuaries, am I correct?

A. Yes, I was.

Q. Would you have even dreamed of profiting on the members of the association on an insurance program to 50 percent of premium?

A. It wasn't a matter that entered my thinking at all, Mr. Gregory, because the society being what it is you would never get the members to agree on an insurer for an association plan. It just wasn't a matter of consideration.



Q. And you certainly wouldn't get actuaries to agree to pay their own association 50 cents on the dollar for the privilege of being insured, would you?

A. Probably not. I wouldn't think so.

Q. But you can get lawyers to agree, is that what your testimony is today?

A. Evidently they have. They would appear to [2693] have agreed to go along with that.

Q. They certainly have. Do you know to what extent the members have agreed to go along with this over the past 25 years? How much profit has been made by the bar?

A. In dollars, percentage?

Q. Why don't we say dollars?

A. Since inception of the program?

Q. Inception is fine.

A. The 1950's? All right. I would suppose 60-70 million dollars, something like that.

Q. And the lawyers allowed their association to take 60 to 70 million dollars from them?

A. Evidently, yes.

Q. Can you name for me a single professional association, doctors, lawyers, accountants, orthodontists, et cetera, that make any profit from their insurance program at the expense of the members?

A. Not specifically. There are a number of them that are compensated for their services on a percentage of premium income basis rather than some cost accounting or cost-plus basis. So there might be some that derive some profit, but I think it would be at best a few percent.

Q. Minimal?

[2694] A. I would say minimal, yes.

Q. And in responding yesterday to the question of Counsel for the Government in terms of who keeps experience credits you talked about banks, you talked about oil companies, you talked about credit card companies,

you talked about credit insurance, and you talked about some college alumni programs, but you did not talk about professional associations because there are not any, except the American Bar Association according to your understanding, isn't that correct?

A. I am not aware of any, that is correct.

Q. Mr. Barnhart, you are a professional advisor to associations?

A. Yes, sir.

Q. You have dealt with at least four major associations? Correct?

A. That is correct.

Q. You have dealt with some of the finest insurance companies in the United States, some of the biggest, New York Life, Mutual of Omaha, John Hancock, Century, all big mutuals, and Provident Life of Chattanooga which I think you would agree is a reputable and one of the finest group carriers in the country?

A. Yes, sir, large and reputable companies.

[2695] Q. And you have represented large and reputable associations.

Can you seriously contend, as a professional actuary with your experience and your background, that the members of the American Bar Endowment did anything except permit this association to keep the money for the last 28 years for charitable purposes?

A. They have permitted the association to keep the money. I don't think I could necessarily agree one way or another that it was specifically for, in their minds, for charitable purposes. I think they were buying insurance at a reasonable price in the marketplace and that many of them undoubtedly were buying the insurance because they thought it was a good buy, that they thought it was a reasonable buy for the money, never mind the retained dividend by the ABE. I just can't imagine that that large



number of people, thousands of people would willingly and deliberately do this simply because of a momentary impulse. That to me is an unlikely explanation. I don't know.

Q. Well, I guess we all have our own views of human nature, but that is not the purpose here today.

Again in your professional experience—and I am just about finished—don't you know full well [2696] that if lawyers, contentious creatures that we are, wanted to change this program in the bar they could have changed it any time they wanted to?

A. I would think so, yes.

MR. GREGORY: I have no further questions, Your Honor.

MR. DENNIS: Your Honor, could we have a short break at this time?

THE COURT: How are we doing as far as expected time with this witness?

MR. DENNIS: I don't think very much longer, Your Honor.

THE COURT: Okay, let's take about ten minutes.

(A brief recess was taken.)

THE COURT: Mr. Dennis.

#### REDIRECT EXAMINATION

BY MR. DENNIS:

Q. Could you state for me, Mr. Barnhart, what the key consideration in your mind was in determining that the dividend received by the American Bar Association was compensation?

A. That it was money retained by the Bar Endowment that did not represent a refund to it of its own monies laid out. \* \* \*

\* \* \* \* \*

[2719] A. I think the Ohio rates are also expensive at younger ages. You reach a cross over point.

Q. Look at Oklahoma. Is \$195 more expensive than \$200.

A. No, \$260 is more expensive than 200.

Q. The net is 105 in Oklahoma?

A. Oh, yes, correct.

Q. So every one of the Oklahoma columns is cheaper, is it not? Not more expensive?

A. You are correct if you look at the net rate. It does become cheaper for Oklahoma, yes.

Q. And you were going to point to something else? Ohio?

A. Well, I was simply pointing out that at the younger ages the Ohio rates are higher.

Q. \$12 higher, and you took no account of the dividend, correct?

A. That is true.

Q. And the brochure for the Ohio bar says that it has a very favorable dividend history, doesn't it?

A. I don't recall any statements it made. In looking at that brochure all I could determine was that it did not seem to indicate what the actual record of dividends was. I looked at quite a number [2720] that were higher, but I sure couldn't tell you which ones those were.

Q. You can't name one, can you?

A. I looked at Idaho, Arkansas, a lot of plans. And at this point I could not recall which were and which were not.

Q. You can't name one?

A. I could not specifically name one, no.

Q. Let me talk about New York a second. I should have done that before. Mr. Dennis asked you some questions and got me interested again.

Can you give me one reason, one insurance reason why a member of the New York State Bar who wanted only a \$100,000 in insurance would purchase ABE insurance rather than the New York State Bar Insurance?

A. No. If I were a New York Bar member and only wanted a hundred thousand I would buy New York Bar.

Q. Unless you wanted to make a charitable contribution to the ABE?

A. If I were sufficiently motivated to make a charitable contribution then I might buy American Bar Association.

Q. You are a fine person, it wouldn't take that much motivation, would it?

\* \* \* \* \*

[2745] Q. Can you tell me what would cause an individual who is a member of the New York State Bar to pay \$95 more going in for the privilege of having ABE insurance rather than New York State Bar insurance at age 35 to 39?

A. Again, you know, it's obviously hard to say for any individual. I think there would be two or three likely things that I would deem to be the most probable. One might be that for whatever reason he hasn't been paying attention to the New York State Bar mail.

Q. I think we assumed full knowledge in the Judge's hypothetical statement to you.

A. Okay, he is saying he is aware?

Q. Fully aware, fully informed.

A. In that event I think it would have to be—if he chose the Bar Endowment plan in lieu of the New York State Bar plan, it would have to be either that he just felt the Bar Endowment program had better guarantees or he was mad at the New York State Bar. I don't know how many of them might be mad at their state bar associations. But there would be some bias in his mind, some reason in his mind why I don't like the state bar plan but I will buy this one.

[2746] Q. I am correct that the New York State Bar plan had guaranteed rates and the ABE plan didn't, so a fully informed person would not have that bias?

A. No, he shouldn't have.

Q. So you can't think of a rational reason why someone would choose the American Bar Association Plan over the New York State Bar plan?

A. I would doubt,—I would be inclined to doubt that whatever reason is there that it would be a cold rational reason.

Q. Could we not agree that that would be even more correct for someone who was a second-year member of the New York State Bar plan who would have to pay \$189 more to seek ABE insurance?

A. That is right. Once a person enrolls in one of these association plans they are a great deal more likely to stick with it, whatever it is, than to switch to another plan.

Q. Do I understand as to Table I in response to Judge Kozinski's questions you told the Court in effect there are a number of features on individual insurance that make it more attractive than coverage under association group insurance?

A. Perceived to be.

Q. Perceived to be?

\* \* \* \* \*

[2873] Whereupon,

EDWARD E. MURPHY, JR.

a witness called for examination, having been first duly sworn, was examined and testified as follows:

MR. WATKINS: Your Honor, we want to thank Mr. Murphy for waiting while we finished qualifying Dr. Plotkin, and for his time to come out here from St. Louis. He has a small firm and he cannot take a lot of time from it. So we will keep you as little as possible, Mr. Murphy.

THE WITNESS: Thank you.

DIRECT EXAMINATION

BY MR. WATKINS:

\* \* \* \* \*

[2878] Q. Would you explain what you mean by an attractive proposition?

A. It was cheap.

Q. And would you have said the same thing about the disability insurance, why you purchased that?

A. Could I add another reason? In 1955, I left my position with a large St. Louis law firm and went on my own and it was a scary proposition and I was looking for all the security I could find. So that was a very traumatic year for me was 1955.

In 1961 basically it was the same thing, I felt that — well, in 1961 I had formed our firm of Murphy & Korten Hof, we formed that in in 1960 and we had the rent and salaries to pay so I was concerned with what might happen if either of us were disabled.

Q. Were there any other reasons why you bought the insurance?

A. Well, basically financial security in the event of illness or accident.

Q. When you bought the insurance, were you aware that the American Bar Endowment received the premium refunds?

A. I remember that very clearly. In the first application that I signed back in 1955, I remember. There was never any doubt in my mind that that is the [2879] way it worked.

Q. As a term of the contract, of the application, how would you characterize that term as part of the contract?

A. The term?

Q. Yes, would you say it was boilerplate or a term you could not change?

A. As I recall it, it was not an optional thing. You either agreed to that or didn't get the insurance.

Q. And you did sign the application that stated in effect that you assigned the right of your refunds to the Endowment?

A. Yes.

Q. Have you deducted on your tax returns the amounts the Endowment notified you were considered charitable contributions for this?

A. I have deducted it every year that I was told to do it, and one year it was disallowed.

Q. You were audited?

A. Yes.

Q. Do you recall which year that was?

A. I was audited several years, and it was disallowed in 1977, as I recall. The other years, earlier years it passed without any argument.

Q. Are you satisfied that the way the [2880] insurance — with the way the Endowment insurance program is operated?

A. I am not satisfied with the way they handle the dividends.

Q. Have you complained about that?

A. Yes, I have.

Q. I have handed you Exhibits 1411 through 1415. The Exhibit 1411 is a letter you wrote in 1969 to Mr. Bredell. Do you recall complaining about that, the dividend feature, before 1969?

A. I don't think I made a formal complaint about it the way I did with this letter, no.

Q. Might you have talked about it with your friends or acquaintances who were among the leaders in the Bar Association?

A. I probably did. I can't be specific.

Q. I would like to ask you to read portions of these letters. With respect to Exhibit 1411 would you read the first paragraph —

MS. CARPENTER: Excuse me, Your Honor, can't we just put the papers in for the record so we can finish this witness at 12:30.

THE COURT: I think Mr. Watkins wants me to hear.  
MR. WATKINS:



[2881] Q. Would you read the first paragraph of that letter and then the paragraph that begins at the bottom of the page?

A. "For sometime now I have felt that the members of the American Bar Association who participate in its insurance program have not been getting a fair deal. The form letter which I recently received over your signature advising that we are entitled to a charitable contribution in the amount of 68.7 percent of any disability insurance premiums which we paid during the period from November 1, 1967, to October 31, 1968, reinforces my views even stronger."

Then the next paragraph, "It occurs to me that the American Bar Endowment should be looking out for the interests of its members in establishing these group insurance programs and not attempting to siphon off excessive amounts of profit from its members premiums for other purposes. I have yet to hear of any major contributions to the welfare and benefit of the members of the association performed by the American Bar Association. Maybe there are some, I don't know, but in any event I do feel that this amount of profit which the Endowment is earning from our insurance program premiums is grossly excessive [2882] and should be refunded to the participants rather than to any other organization."

BY MR. WATKINS:

Q. Now, with respect to Exhibit 1412, is that the reply you received to your letter?

A. Yes, it is.

Q. Would you read the paragraph at the very bottom of the first page of that letter?

A. "I am sure you realize that the function of the Endowment's insurance activities are to provide contributions from members that accrue via dividends or expense credits to be used in the carrying out of the Endowment charter purposes in the areas of legal education and the advancement of jurisprudence."

Q. And who wrote that letter to you?

A. Well, it apparently was dictated by Richard S. Breiner but signed by someone else.

Q. Now, with respect to Exhibit 1413, you wrote that in reply to the previous letter?

A. Yes, I did.

Q. Would you read the entire text of the letter, please?

A. "Dear Mr. Breiner: Thank you for your letter of October 20, 1969 responding to my earlier letter concerning our insurance program. I am happy [2883] to know some of the details of the workings of the insurance program. The only matter I would question in your letter is your statement in the fifth paragraph that "the function of the Endowment's insurance activities are to provide contributions from members that accrue via dividends or experience credits to be used in the carrying out of the Endowment charter purposes.

"It was my impression that the principal function of the insurance program was to benefit the members of the American Bar Endowment and the incidental function was to provide contributions for the Endowment. If I am incorrect in this, then I would suggest we set up an independent insurance program for members of the American Bar Endowment that has as its only purpose the providing of low-cost group insurance for its members and let those who are interested contribute to the Endowment. I know John Lashley personally and may have additional conversations with him regarding this matter."

That is in reference to something he said about John Lashley being the head of the Insurance Committee in his previous letter.

Q. And did you receive a letter from Mr. Lashley?

[2884] A. Yes, I did.

Q. Is that Exhibit 1414?

A. Yes.

Q. Would you read the second paragraph of that letter, please?

A. "I should like to comment, however, on your letter of October 22, that clearly the principal function of the insurance program is to provide a means of raising funds for the charitable and educational purposes of the Endowment. The tax exemption would not be permitted otherwise. However, I believe you would find that the insurance is competitive with that offered by other carriers so that an independent insurance program would not be likely to save you much money."

Q. Now, did you receive a reply from Mr. Breiner as well? Is that Exhibit 1415?

A. Yes.

MR. WATKINS: Your Honor, I would like to move those five exhibits be admitted into evidence.

MS. CARPENTER: No objection.

THE COURT: You say those five? You mean—

MR. WATKINS: 1411 through 1415.

THE COURT: They are admitted.

\* \* \* \* \*

[2903] A. I just think I was cutting down on my insurance premiums, I had other uses for the funds.

Q. Did you have an individual disability policy once?

A. Yes, I had an individual policy. That was the first policy I bought. It was sort of semi endorsed by the St. Louis Bar Association but it was not a competitive type policy and it had a lot of loopholes in it and I did not feel comfortable with it, particularly comparing it with these other policies that came out, the Missouri Bar policy and the American Bar policy.

Q. You still have the American Bar Association insurance, right?

A. Yes.

Q. Why did you continue to purchase the Endowment's life and disability insurance in spite of your dissatisfaction with the way they require you to assign the dividend to the Endowment?

A. Number one, I needed insurance. Number two, their rates were competitive. Number 3, I felt that other than my disagreement with them as far as the dividend policy is concerned that I was happy to be a part of the American Bar insurance program. I felt they would certainly have the clout to deal with the [2904] insurance company and see that the policies were satisfactory for the participants.

MR. WATKINS: I have no further questions. Well, excuse me.

BY MR. WATKINS:

Q. Mr. Murphy, Mr. Smith testified that an ABA member could change the program, that is the insurance program any time at an ABA meeting. Do you agree? Or at least that he could change the ABA's policy about not sponsoring an insurance program?

A. I would disagree. I tried my best to change it and I did not succeed. I don't think I could have done any more. These people were personal friends of mine that I had known through the years that I had met and conventions, that I could talk to on a first name basis, I laid out the arguments as best I could and if I did not persuade them in that way I don't know what more I could have done.

MR. WATKINS: Thank you. That is all.

MS. CARPENTER: Your Honor, I could ask Mr. Murphy to read the fifth, sixth and eighth paragraphs of that letter which were so pointedly omitted but I will simply point those out to Your Honor, and they say exactly what you would expect them to say having been skipped by the Government.

[2905] THE COURT: There were a number of letters out of which selected paragraphs were read.

MS. CARPENTER: This is the December 19, 1980 letter.

THE COURT: Is this the one I don't have a copy of?

MS. CARPENTER: It is 1420, Your Honor, I am sorry. The fifth, sixth and eighth paragraphs were omitted in the reading of juicy parts that we had.



THE COURT: I see, there are the juicy parts and then there is the gravy. This is the gravy. Fine. Five, six, seven, and eight. I see. That is it?

MS. CARPENTER: That is it.

THE COURT: Okay.

#### CROSS-EXAMINATION

BY MS. CARPENTER:

Q. You have been in the ABE insurance program from the beginning, right?

A. Correct.

Q. And you understand it pretty well, don't you?

A. I thought I did.

Q. You understand that the program is used to raise charitable funds for the bar?

A. Yes.

Q. In fact that is what you have been [2906] complaining about for many years, is it not?

A. Right, yes. I was not aware of the amounts that were raised until I got involved in this thing though. That was an eye opener.

Q. That was back in the 1960s and 1970s you started to realize the amounts involved in terms of percentage of your premium?

A. My first letter was triggered by 68 percent refund. That kind of shocked me.

Q. That was back in the early 1970s?

A. 1969.

Q. I stand corrected, 1969. And a deduction for charitable contribution with respect to the ABE program was disallowed in 1977?

A. I believe that is correct.

Q. And you continued to take that deduction in years subsequent?

A. Yes, I did.

Q. And I take it you would like to see the program changed and have the dividends used for the financial benefit of the members?

A. Correct.

MS. CARPENTER: No further questions, Your Honor.

#### REDIRECT EXAMINATION

[2907] BY MR. WATKINS:

Q. You at least want the option to determine what to do with the dividend, as opposed to having it required to be assigned to the Endowment?

A. I would like an option for myself. What other people want to do with their money is up to them. I would like an option.

MR. WATKINS: Thank you. No further questions.

MS. CARPENTER: No further questions, Your Honor.

THE COURT: Mr. Murphy, you testified that you first acquired the ABA insurance, life insurance, in 1955 when you left a large St. Louis large [sic] firm to go out on your own?

THE WITNESS: Yes.

THE COURT: What had you been using for insurance before 1955?

THE WITNESS: I had some individual policies that were purchased actually by my father when I was in my teens and early twenties. He transferred those to me when I got married, as I recall, or shortly thereafter, and I started paying the premiums on those, so that was my insurance before I started in the ABA program.

[2908] THE COURT: And you discontinued that —

THE WITNESS: No, I still have those.

THE COURT: I see. So the ABA insurance was not a substitution for anything, it was an addition?

THE WITNESS: Additional, right.

THE COURT: Thank you very much. Anything further?

(No response.)

THE COURT: Mr. Murphy, you are excused.

(Witness excused)



Whereupon,

IRVING H. PLOTKIN

a witness, called for examination, having previously been duly sworn, resumed the stand and testified further as follows:

\* \* \* \* \*

[2930] A. But I was forming an opinion on the case from looking at the documents and I asked them to find and to look with very much diligence, and I did, too, any documentary evidence which say, and I realize I am jumping ahead to the conclusionary thing but this is an important basis of my testimony—one contemporaneous document that said it doesn't matter that this price is not—the price we charge for our insurance is not very attractive in the market because we have what I say in economist jargon very inelastic demand, because people are motivated to buy the insurance because they want to give charity, not because they want insurance. I phrased that in 6 or 7 different ways and I asked for as exhaustive a search as could be made, and I think I asked you and your colleagues to call to my attention anything that said that. And the reports I made of my own searches and all the information I got back seemed always to say just the opposite. I think I have had some questions in depositions, or I participated in depositions where the question was asked, is there any document which says we can raise this price because people really don't buy it for insurance, it is a vehicle for giving charity, we are not to worry about the price [2931] elasticity of demand, what would happen if we raise our price, or we do not have to keep the price within a competitive orb, we are, if I can use the word, hors de commerce, outside of commerce, in terms of how we have to price ourselves. And I saw not one statement like that in the documentary records and I saw literally tons of statements that work the other way. And I saw a

constant worrying as to whether we were within this envelope of normality, envelope of competitive activity done not in light of this lawsuit, but done for parochial purposes at the time. Done by the insurance carriers for their purposes, independent of the ABE's case, and done by the insurance carriers with respect to their ABE client. That was a constant monitoring back and forth of the market, and never a statement "Well, we charge more but it really doesn't matter because people regard it primarily or even secondarily as charity, we can get away with the higher price." And this is what most of the search was for, and the search turned up quite the opposite. And I don't know how many thousands of pages of documents were looked at in that regard. I am not prepared to say that there isn't such a statement somewhere. But I am prepared to say unequivocally I have not found it.\* \* \*

\* \* \* \* \*

[2941] A. The net, after all costs are satisfied, when you deduct all costs from the gross revenue received or the total premiums the members pay, you get what I have called pi, profit, and sometimes it was called contribution. Although contribution was used to mean total premium contribution, because that is the official insurance lingo for it, meaning revenue, but you can say this was the gift that the members gave to the ABE. One way of measuring the gift. So that is where I think—I think that identifies all these symbols in terms of the words used to discuss the ABE operation. If I have not made myself clear, please ask.

Q. Could you from that analysis determine whether an activity is conducted in the commercial competitive fashion?

A. Absolutely not. It can only give you a part of the story. Because I could write precisely the same analysis down if I wanted to stipulate that I am considering

something which without doubt is a charity, wanting to maximize the contributions it receives. [2942] While it would never talk about it in these words it would go through the same calculus, pi would be the total contributions. The total contributions are net contributions that really has at its disposal the total gross receipts from people it solicits, minus the cost it incurs in receiving them.

Think about a charity who wants to raise funds we selling tickets to an opera gala. First of all, should we sell all the tickets at the same price, should we have front seats for people who give more and back seats for people who give less. But as I set aside that question, should we charge \$100 a ticket, \$150 a tickets, \$200 a ticket. The more we charge per ticket, the higher will be our profit on each ticket. Again assuming that somehow our costs vary with the number of tickets we sell, which is perhaps not a good example, because it is a fixed cost operation, but the less total number of tickets we will sell. So in determining price on the fundraising activity, they would essentially go through the same type of analysis. So I don't believe that you can answer the question as to whether or not something is a commercial activity merely by looking at whether it has satisfied the usual businessman's calculus of maximizing pi, maximizing profits with concern for the effects that P [2943] has on revenue via its effects on quantity.

\* \* \* \* \*

[3042] BY MR. DENNIS:

Q. In light of what you have laid out, can you explain I why the ABE's insurance programs are so profitable from an economist's standpoint?

A. Well, yes. Because the ABE has a very valuable I will call it asset, that is the word I use as an economist, very valuable intangible, if you will, when viewed by the insurance carrier. It will allow the insurance carrier via the

ABE access to a very [3043] special subportion of the population, which they could not get access to without a special product and special prices and alleged to be specially designed for that subportion, namely the attorneys.

And it could do so by having advantages of group selling of insurance, using direct mails, direct marketing, not using an individual agent who individually would visit each insured. By the way, in some cases, association insurance as we have heard is sold by individual agents. The association together with the insurance company employs the individual agents for their somewhat lower than standard but yet individual insurance agent's commission.

These commissions as we have heard have run 50, 60, 70 percent at least of the first year premium when sold. Not having the individual agent and the attendant costs of visiting each individual, the association can offer its members insurance that is attractively priced compared to their normal and natural alternatives, and the alternatives that are forcefully presented to them, mainly that by agents, now even some by direct mail. Yet, while the price paid by the individual is lower than his alternatives, the association in turn in dealing with the insurance company can bargain for a much lower price for itself [3044] on the wholesale level, so to speak, because the company would have no way — by dealing with the association, it is not losing business it could otherwise get that directly and it is not losing a very sure flow of business. One way the deals are set up where the association takes the first layer of uncertainty and the insurance company will not likely lose money — it has a margin of protection almost 50 percent on its chance from a normal insurance policy of whether it would ever wind up in the whole because of untoward actuarial risk. The only thing that no one seems to have protected against here is some large calamity, an ABE meeting. It doesn't seem that one possibility is covered in some sense. But in the general sense, the insurance com-



pany gets a very good deal, gets access to a population he cannot separately access. The association can make an attractive offer for the individual and still make a very high profit on what it sells. That doesn't mean that if it chose to make a lower profit it wouldn't sell more insurance to its members, but even those who buy at the higher price than it has to charge can still get a good deal and the association can wind up with what appears to be a high profit per dollar of premium. There is nothing mysterious about it.

\* \* \* \* \*

[3048] I think you have indicated that you have heard their testimony. Has that phenomenon been adequately described by the witnesses, including Dr. McGill?

A. Well, I think in general by now there has been a very good general description. I think perhaps Ms. Khachadour from her own experience as a regulator in California gave the best general definition. Dr. McGill just said he was I think somewhat familiar with it and that it could exist in the association where the association benefits from the experience—benefit of the association is a function of the experience on the group policy sold that is.

I would say the most important points to emphasize is that the power is because the association or the intermediary is the one who effectively chooses the insurance carrier, and as an economist, I would probably say that we would—the general economic words would be there is an incidence of market power that the association has won over the carrier and to some extent even over its membership, although this doesn't mean a pejorative connotation.

Q. In addition to the high profits earned by the Endowment is there any other evidence of the ABE's market power vis-a-vis the carriers it has selected to [3049] provide insurance to members?

A. Carriers it has selected? Did I hear right?

Q. Yes.

A. Yes, I think we mentioned what might be called the annual tribute which wouldn't be worth mentioning except for the fact that it is an example of the very kind of thing and the same type situation that was specifically pointed to by the California Insurance Department.

I think the fact that the words of one of the Mutual of Omaha witnesses, "the ABE sets the price of insurance" well, that can't be strictly true. Legally I think the carrier has to set the price, but I think saying effectively that the intermediaries set the price of insurance.

I believe the unique escrow arrangements, at least that is what I heard at the trial, for the ABE's business than for the business of other associations, meaning to me that the ABE has perhaps a better bargaining position because of a better maybe mortality, morbidity experience of its members.

The cash flow or the float on the premiums seems to have carefully been worked out to the advantage of the ABE. And this is really something—a tribute to Mr. Breiner, because one thing insurance [3050] companies have been generally expert in doing is having the cash flow work to their advantage, giving rise to investment income, so much so that in current years, most of the income from the insurance company comes from investment income and not from any underwriting profit it may make.

But when you deal with the clever intermediary like an independent agent who has a good book of business or an association, that is where the carrier often has to give up some of the float to the intermediary.

Another evidence or maybe just evidence of the basic phenomenon was that the association was able at the drop of a hat really to stick carriers on the medical plan, I think, when it wanted to, and get a better bid from one carrier versus another. That is the carrier would lower its retention rate. Retention rate is meaning how much profit the



carrier makes out of the business. This is a very interesting bargain. I can't go to an insurance company and say sell me an insurance policy where rather than going for your usual 5 percent underwriting profit margin I want you to go for 2 percent, but in fact that is what happened in the bargaining between the association and the carriers.

[3051] In a sense the association vis-a-vis the carrier basically had all the marbles, all the bargaining chips. As far as I can tell, it has exercised every one of them. And again, there is nothing wrong with doing that, but I think it is an indication of the relative bargaining positions of the individuals.

There are a huge number—if you take all the companies that qualify to write life as well as accidents and hell we are talking about thousands of insurance companies, there is only one ABA and one ABE to give you access to that broad national membership.

Q. Dr. Plotkin, wouldn't it follow that the retail consumer that you have described, in this case the ABE's insured members, would necessarily have to suffer if the ABE makes such profit?

A. No, I think we have adequately discussed this before—

\* \* \* \* \*

[3128] A. But I think it was. I know I entered into no kind of recruiting negotiations with him. I did before submitting his name to the Government check out his willingness and I remember him saying his major concern was the time commitment it would involve and I advised the Government of that.

Q. I am not sure which question elicited that response.

A. You asked if I recruited any witness and the only one that word can come anywhere near is Mr. Barnhart's.

Q. Did you ask any person who is listed as a witness but did not testify to testify for the Government in this case?

A. Well, I did approach Ms. Furth to ask her to work on this case.

Q. She is a colleague. You know I am not interested in that.

A. Well, what you would have to show me, sir, is—I think the answer is no, but I don't have the witness list before me.

Q. Let me ask a different question then. From the time you were hired as an expert in this case have you ever approached any individual at any time anywhere and suggested to that person that he or she [3129] testify for the United States in this case?

A. I think the answer to that is yes in a somewhat trivial way, which I think I should explain to you.

Q. Please do.

A. As part of my normal work, not necessarily related to this case, I see a lot of attorneys and I work with a lot of attorneys in an insurance regulation-insurance business setting. Also I am related to an attorney. And I think I asked my brother-in-law whether he had ever bought this insurance—I didn't seek him out or phone him to ask that question, but just "By the by, what are you doing," and "By the by, did you ever buy this insurance," and I was surprised when he said yes.

Q. What is the name of your brother-in-law?

A. John Bufe. And I was surprised when he said yes, because I knew he was as poor as a church mouse for many years. And he had also just completed a move out of Washington, D.C., where he had worked for a labor union to join a firm.

Q. You are saying you made a trivial suggestion to him that he might testify?

A. Well, yes, in fact I said I will mention this to the Justice Department people because I know [3130] you have just moved to Texas and this might be a way of your getting a trip back to Washington, D.C.

Q. And in fact he appeared on their witness list?

A. I am not sure of that.

Q. And in fact I was trying to get his address to subpoena somebody down in what's its name, Texas, that he was on the list?

A. I agree it is a what's its name for sure. So I was sure the allure of coming back to the big city—

Q. Other than your brother-in-law have you asked any person in the world to be a witness in this case?

A. Again even further removed, but jocularly I discussed this question with an attorney I am quite sure not named on any list who used to be Deputy Insurance Commissioner of California, again "What are you doing, what is keeping you busy lately," and he said that he did buy one of these products. In fact he made a very careful study when he left Government service, and including his dues to the ABA which he would not otherwise pay, it was the cheapest disability insurance he could get and I said "Would you be willing to testify to it," and he said "No," [3131] and he gave me an interesting reason.

Q. Point of fact: You solicited him to testify for the Government in Tampa, Florida, at the NAIC meeting on September 19, 1983, did you not?

A. Solicited would be a very strong word. I think it was at an NAIC meeting, and it must have been in Tampa I had that discussion with him as part of taking the opportunity to ask people who I knew understood the insurance world and was also an attorney what he knew.

Q. He is also a former Deputy Insurance Commissioner or Director in California; is that correct?

A. I said that.

Q. And you asked him to testify for the Government in this case, correct?

A. No, I asked him would he want to, would he be willing, should I put his name to the Government.

Q. I am sorry, I misunderstood.

A. I had no authority and it was in one brief conversation more as "Would you say that, would you be willing to say that," and he explained to me why he would not be willing to say it.

Q. Who else did you ask to testify at the Tampa meeting of the NAIC on September 19?

[3132] A. I don't recall. Well, I discussed this with a large number of people, again in a passing mode, "What is keeping you busy, what are you doing." Also sometimes doing a little bit of brain picking, "What is your personal history with respect to this."

Q. And this is three days after we had received your opinions as an expert in this case?

A. That is true. I continued to brain pick and look at anything that I could find. I don't know that any other conversations would you testify or would you be willing to testify, shall I tell the Government to interview you, maybe they would find your story interesting type. But I talk to a lot of people and it is the usual topic of conversation at an NAIC meeting where you run into people you have not seen for either six months or at least three months, catching up on what you are doing. Especially when you, as I was working on something which in a wholly different setting, the tax setting, was still very much the nature of the work of these people and involved the law and involved insurance. I am quite sure I spoke to lots of people about it. But I was not out looking for witnesses to testify.

Q. You were not out beating the bush for witnesses?

[3133] A. I was not out beating anything. I was however sensitized to the fact that this is an opportunity to get very frank opinions on what made people do what they do; a very, very difficult question ever to grapple with.

Q. Did you attend a meeting of the Medicare supplement and other limited benefit plans (B) task force of the NAIC in Tampa, Florida, September 19, 1983?



A. I did indeed.

Q. Am I not correct, sir, that a transcript was made of the proceedings of meetings of that task force?

A. I think in that case a transcript was made at that time of that task force. It was not uniform that task force meetings of the NAIC are reduced to transcript form.

Q. Am I not correct that Commissioner Mikelow of Arizona was present and presided at this meeting?

A. I think yes, he was chairman of the task force.

Q. And Commissioner Don Ainsworth of Missouri was present?

A. I believe so.

Q. Am I not correct, sir, that the purpose of the meeting was to consider whether the NAIC needed to [3134] develop additional model laws or regulations governing direct mail insurers and out of state trusts?

A. Well, in part. It was also to receive reports relating to those matters.

Q. And at that meeting did you not rise and ask a question from the floor?

A. I did.

Q. Did you not inquire whether in connection with association group policies any of the commissioners were aware of any law or regulation which would affect the situation where an applicant for coverage under a group policy was required to return the dividend to the policyholder?

A. Precisely.

Q. And did you not state—

A. Think those are my words.

Q. Did you state the purpose of this question was you were simply "brain picking"?

A. That is just what I was doing.

Q. And just what you said. You did not disclose that you were an expert witness in this case having already formed your opinion on this subject, did you?

A. In asking the question of the commissioners in their formal session, I said I was brain picking to [3135] know whether there is any law in any state. I had about a dozen different insurance departments represented on that committee that would prohibit the preassignment of dividends as a condition of obtaining association insurance.

Q. Did you receive any response to your question?

A. I didn't receive a definitive response. I interpreted the response I received as saying that they don't think that that would be permitted by law but it seemed to be unclear in my mind and perhaps they would look at it. It was a kind of unfair question to put to them even in that, the appropriate task force.

Q. Did not Commissioner Ainsworth of Missouri state to you in response to your question, Dr. Plotkin, that it would seem to him that the practice that you described would adversely affect the marketability of the insurance product in question?

A. He may or may not have. I just don't recall, sir. I am sure there is a transcript of it and it would say what it says.

Q. But your recollection now is that that may or may not have been his response?

A. The question I asked, sir, was whether there [3136] were any laws that prevented it and it was to that question I received no definitive response other than we would look.

Q. You were told by a state insurance commissioner at that meeting that the practice in question would adversely affect the marketability of the product and we have not heard any reference to that in your testimony, have we? That calls for a yes or no answer.

A. I have not referred to Mr. Ainsworth's comment, you are right.



Q. Am I correct that the last time you testified in Court was in the Mobil Case in the Court of Claims in July of 1983 for the Department of Justice?

A. Yes, sir.

Q. How much were you paid in that case? How much was Authur D. Little paid in that case?

A. You have probably reviewed the transcripts more recently than I. Could you remind me of the number? I don't have it.

Q. May of 1983 you testified for the Department of Justice in Colorado, did you not?

A. Yes.

Q. How much time did you put in on that case?

[3137] A. I have no way of remembering how much I put in on the Colorado case. I am sure time records would show.

Q. How much time did you put in on the Mobil Case?

A. Again, as I sit here now I don't remember. A lot more time on the Mobil Case than the Colorado case I am sure.

Q. 1981 you testified for the Justice Department in the Claims Court on the valuation of good will and stock?

A. Primarily the valuation of good will of the Studebaker Corporation in 1911, I believe. Stock came into it because it involved a capital market and the stock market of that day, and the so-called watered stock.

Q. Do you know how much you were paid in that case?

A. No, sir. First of all, you always mean Authur D. Little and I don't know how much Arthur D. Little was paid.

Q. Is it not fact, Dr. Plotkin, you have printed on Authur D. Little stationery questions and answers that you send to counsel so you can be qualified as an expert witness?

[3138] A. What I have is a typing that my secretary did from a transcript a number of years back of Q and A to not sensor [sic] but to give to counsel if they want to know questions that will bring out what areas I worked in, and it came about by one counsel having done a very thorough job on a record and I asked my secretary to reproduce it, so we don't have to each time sit down and talk out with counsel what questions should you be asked in terms of your experience outside of the instant case.

Q. Let me ask you about this case:

What did you mean on Friday when you said that the role that you had taken in this case, or Authur D. Little, was unprecedented in your experience?

A. Sir, can I start by saying what I did not mean, because I think I may have misled you based on an earlier question.

Q. No, tell me what you meant.

A. It meant the degree to which my colleagues, primarily Ms. Furth and myself, were requested to actually write out, give, suggest questions to counsel in what I call real time, during depositions, during trial. While there is always some of that involved in being an expert, in terms of the matter of degree of how much we were asked to do, that it seemed to me [3139] that this was more than I had ever experienced before. I think I understood the reasons for it, and the necessity of it, but it was outside of my usual experience and involvement with the case.

Q. And it made you very nervous, didn't it?

A. It made me uneasy, because as I said I think during direct I would not do such a thing in a subterfuge, writing out questions and suggesting questions. If so I would make it obvious I was doing so, and I was worried that it might have the appearance of impropriety and I checked a number of times and was told that that is not improper. And where in my view I want to be very sure that I understood what was said and had the opportunity not of having to read a deposition and say "Oh, I wonder what he

meant by that or what would he have said if asked such and such, had I the opportunity to actually suggest that the questions be asked," that that is an appropriate role. I suppose part of the reason is generally when I come in a case much of the discovery has already gone on, the discovery certainly of all the fact witnesses has generally already happened, and I have the unenviable position of just reading the depositions without being able to control whether the words are used in the way of having meaning to me. So [3140] it was unusual and outside of my experience to be involved in the case at such an early date vis-a-vis the discovery of fact witnesses. It is not unusual to participate in the deposition of an opposing expert witness.

Q. All right, now, you participated, you or your staff, in a lot of depositions other than expert. You sat in Chicago a day and a half with Ms. Locke?

A. I said that was the unusual part. I consider that discovery of a fact witness and usually I don't have the ability to be a part of the case while that is going on. I get their deposition as it has been taken and I am told read it for what it is worth.

Q. In this case there is no problem for you because the script of the depositions was written by Authur D. Little was it not?

A. I don't think that is a fair way of saying it.

Q. Who sat there and passed questions all day long to the United States Department of Justice lawyers?

A. Sometimes when I was there I passed questions, sometimes when Louise was there she passed questions, but I don't consider that writing a script [3141] for them. But it is certainly suggesting questions to ask. More importantly I think sometimes suggesting follow up questions and being sure that the words are used right.

Q. Let's direct your attention to the deposition of Dr. McGill.

A. Yes, sir?

Q. This is after you reaffirmed your opinion of September 16 by the witness papers being filed on September 30.

A. Excuse me, can I just with that prologue say I don't recall doing anything vis-a-vis the Government in the period between September 13 and September 30. There was no active reaffirmation.

The research certainly was continuing but I did not—I don't recall being a party to that so-called reaffirmation.

Q. You sat at Dr. McGill's deposition on Mr. Dennis' left hand whispering in his ear all day long?

A. Indeed I did.

Q. To the point where I had to ask you on any number of occasions to please let Dr. McGill finish his answers before you commenced your whispering?

A. Yes, you did.

Q. I had to ask you to stop tugging at Mr. [3142] Dennis' sleeve and give Dr. McGill the chance a gentleman should have to respond to your questions?

A. At one point, after you asked me to stop whispering at him, I tugged at his sleeve to get his attention before he went onto the next question and you then asked me to stop tugging at his sleeve.

We progressed by the time of Dr. McGill's questions to your saying you had no objection to my suggesting questions in between the answers as you objected previously.

Q. All I was asking you to do was listen to the answer, right?

A. Yes.

Q. Am I not correct among the papers on your desk Friday were both the proposed and final rules of the Federal Trade Commission giving administrative law judges discretion to allow a non-lawyer expert to cross-examine another expert and to do so as an advocate?

A. I don't know about the last portions. I really have not had a chance to read them. There was the proposed and adopted rules of the FTC that would allow one expert to cross-examine another expert in his own field.



Q. And you carried them to the witness stand in [3143] this case?

A. They were in my file, yes, sir. I had received them while I was here in Washington.

Q. And—they were not in your files. They were laid out on the table, because that is where we got the papers from Friday.

A. I am telling you they were in the one file that I brought and spread out onto the table.

Q. As I understand your testimony, this unprecedented methodology for organizing and managing depositions in this case was necessary because the Government attorneys could not understand insurance terminology and insurance market conduct; is that correct?

A. In part it seemed to me that it was necessary in part because when I asked that certain areas of economic evidence be explored I had great difficulty in achieving understanding in what I was saying; the subtle differences in words that were used in insurance, that this seemed to allude [*sic*] them.

Q. Subtle differences you mean in individual insurance, in term insurance, in group insurance, in gross premium, net premium? Are those the subtle differences we are talking about?

A. Yes, for some people it is apparently very [3144] subtle.

Q. And Mr. Dennis just doesn't have the experience to do that?

A. Mr. Dennis is rather lacking in the experience that I could tell about these terms and economic terms.

Q. Did you ask Mr. Dennis about his experience in this Court in insurance cases?

A. No, I made that judgement based on his performance in the instant case, sir.

Q. Did you ask him how many cases he has handled in this Court involving insurance issues and insurance companies?

A. That was not relevant to me.

Q. What about Mr. Markham, did you check on his experience and capability before you took control of the depositions?

A. I don't believe I took control of the depositions. I believe Mr. Markham did depositions—I know he did depositions and I was no part of the depositions that he did. And—

Q. We had five or six in a day so I would stipulate you wouldn't have been at every deposition.

A. Maybe you should make clear that I was at Ms. Locke's deposition, the beginning of Mr. Zumbrook's [3145] deposition, another very short deposition that interrupted Mr. Zumbrook's deposition by a gentleman who had worked as an insurance age administrator. And then Dr. McGill's deposition. Those are the only depositions I was in. You make me sound as though I had more arms than I have.

Q. You had associates. Ms. Furth was in Omaha for a dozen depositions; is that correct?

A. She was in Omaha. I don't know how many depositions were taken there.

Q. Did I understand you to testify you had a chance before his testimony to meet with Mr. Gardner and to discuss your respective vocabularies?

A. If I said at least that I met with Mr. Gardner the morning—I think it was the morning before his testimony, but rather it was the same morning I am not sure. I do remember a breakfast meeting. In fact I think there were two breakfast meetings; one the day before his testimony and one the day of his testimony. But in both cases I really joined in on the breakfast in progress, stayed for a while and went off to other appointments.

Q. Took no active part in it?

A. Oh, while I was there I had an active discussion, participated actively in the discussion.



\* \* \* \* \*

[3156] BY MR. GREGORY:

Q. During the course of your examination of Endowment documents, Dr. Plotkin, you obviously would have had to have looked at the annual notice to members of the amount of charitable contribution; is that correct?

A. I saw a number of such exemplary notices.

Q. And you saw literature going back certainly to 1972 and beyond, that explained the purpose of the insurance program as a charitable fundraising effort, did you not?

A. Yes, sir.

Q. Now, can we not agree that a lawyer being told, for example, in the life program in a given year, that he had a charitable contribution of 50 percent of premiums, is capable of reasoning that if the money [3157] had not gone for charity his association could have provided insurance for him at 50 percent less?

A. I think a lawyer who thought about it could have concluded that the American Bar Endowment could have provided insurance for less. A good tax lawyer from everything I hear today might have concluded that the American Bar Association could not have done that, or at least they maintain that they couldn't have done it without losing their tax exempt status.

Q. There is no question he could have concluded that the American Bar Endowment could have provided it at 50 percent less?

A. I think he could have suspected that. He might wonder whether the Endowment could strike a deal that the association couldn't for some technical reason or that, but if he thought hard about it I think he could have realized that one or another of the association's aspects of the American Bar Endowment in large could have provided insurance at a lower price to him.

Q. If the lawyer thought real hard he could have figured out that the 50 percent that went for charity could have gone to him?

A. Yes, sir.

Q. Let me make sure I understand your testimony.

[3158] A. You know, when you say thought real hard, I said thought about it. Is capable of thinking about it. I wouldn't want to speculate whether he did or didn't think.

THE COURT: Dr. Plotkin, you must not take everything Mr. Gregory says literally. Sometimes he just says things.

THE WITNESS: Okay. Well, I just get uncomfortable when he characterizes what I said.

MR. GREGORY: Then I won't characterize what you just said.

THE COURT: Keeps things lively.

BY MR. GREGORY:

Q. In order to reach the conclusions you have reached, Dr. Plotkin, has it not been necessary for you to set aside all of the statements by the Endowment concerning the purpose of the charitable program?

A. Absolutely not. I didn't set them aside, I set them right in front of me when I considered the question does notice change the economic answer that I have received. Setting aside is to ignore, to put to one side. I don't see—I thought you said you were not going to characterize any more? It is such an inaccurate characterization.

[3159] Q. Why don't you just answer my question?

A. I am trying to, sir.

Q. Thank you, I really appreciate it.

Now, the bottom line of your testimony is that the American Bar Association as a business has been able to generate over 63 million dollars in profit from the administration and operation of one group insurance program?

A. I think the 63 million dollars is the sum of all dividends they received, less expenses from the commencement of the program.

Q. That is correct?

A. Well, from the operation of a number of such programs, yes, sir.

Q. Well, one program, five different policies, is that what you have in mind?

A. They call them different programs.

Q. All right, from the management of insurance programs for one group, the Endowment has received as profit, according to your economic analysis, 63 million dollars?

A. Yes, sir.

Q. Can you point to any group insurance program in the United States that has achieved such successful results?

[3160] A. Using the technical word of group insurance, which you just used, many lenders running group insurance programs have received—have produced results that dwarf these results by miles and miles.

Q. Are you talking about credit insurers?

A. Yes.

Q. Credit insurers who don't disclose to their insured what their profits are?

A. In general, yes.

Q. Don't even disclose the fact that there is profit? Is that correct? Credit insurers who are dealing with people who are purchasing insurance in the context of a loan transaction? Are those the people?

A. Those are at least one group responsive to your question.

Q. And the same credit insurers whom Ms. Khachadour said abused consumers and had to be regulated? Is that a group?

A. That is a group.

Q. Well, putting aside that group, who else within the general—the biggest definition you can think of of group insurance, who else has made this kind of money on an insurance program?

A. We talked before about title insurance as [3161] another example of the role of an intermediary, but that is not strictly group insurance.

Q. Well, it is a captive group, though, very analogous to credit insurance in that somebody is looking for a different commodity and dealing with a captive insurance company, not technically but in the sense of the title attorney or someone else recommending that company; is that correct?

A. That there is an intermediary who selects a carrier to provide the coverage to the underlying consumer.

Q. Another area that has been alleged to be quite abusive?

A. Yes, sir.

Q. Well, all right, we have covered credit insurance and title insurance. Who else, what other type of group policy in the broadest sense, group policyholder, has achieved these kind of profits?

A. You talk about the broadest sense, as you do, which admitted title insurance, which is not written under a group—

Q. I didn't quibble with your answer to that.

A. I know, but I have to continue in that vein.

Q. Just give me anybody who has made that kind of profit?

[3162] A. Many commercial agencies who work on an individual—we would need the flip side of that blackboard.

Q. You can flip it over.

A. —who work on an individual—who sell insurance to individuals, would have made dollars much larger than those in relationship to their sales of individual life in-



insurance to individuals, although if you scale their dollars by the gross premium charge, they are not as large as the ABE percentage.

Q. And you also don't know whether what they made is profit, do you?

A. I don't know company by company. I do know that pieces of it are fairly profitable.

Q. We are talking about 63 million dollars in profit. Since you flipped the board, go to your box where association is. We will pick up these groups one by one. He talked about lenders already. Mr. Gardner testified that fictitious groups don't make any money and nobody is getting in it any more. You don't disagree with his expert testimony, do you?

A. I know that they are kind of withering [*sic*] on the vine, like. Some of the original promoters made a good bit of money.

Q. The robber barons of the insurance industry?  
[3163] A. I would say probably the robber scoundrels because they are not around to donate large public plazas, so scoundrels.

Q. I will accept that. Again focusing on the box, Mr. Gardner says fictitious groups can't make it, let alone 63 million. We talk about credit card people. Now, credit companies, are they making 50 percent of premium?

A. I mean the credit card—

Q. American Express. There are documents in this case dealing with Firemens' Fund and American Express. You reviewed the documents. How much does American Express get for the insurance program, what is their profit?

A. Well, let's see, American Express is dealing with selling the insurance of a subsidiary.

Q. And we know from your testimony in the Mobil Case that that doesn't count, right?

A. Oh, no, it counts when they sell it to third parties. It is that American Express cannot obtain insurance for itself by dealing with its own subsidiary.

Q. I stand corrected. What does American Express make?

A. I don't know the rate of profit. It also is [3164] a product that has only recently been started, it doesn't have the 20-odd year history of the ABE.

Q. You can't name a credit card company that is making anywhere near the rate of profit the Endowment is making according to your economic analysis, can you?

A. I don't want to even give you the implication otherwise. I cannot name a credit card company that is making the same rate of profit. Some of them may be making the same dollars but they are using a much higher volume.

Q. And some of them can be losing money on their insurance program, too, can't they? Is it not a fact that many credit card companies are in insurance not to make dollars on the insurance per se but to bind the credit card users to the use of their particular credit card?

A. That is possible, but there is very little marginal cost for them in operating the—getting into the insurance programs, basically stuffing things into their mailing.

Q. Did you review the Firemens' Fund depositions in this case?

A. No, sir.

Q. Let's put aside the credit card companies. That leaves us with associations. Mr. Gardner and Mr. [3165] Barnhart, two expert witnesses for the Government, said they couldn't name any association that has come anywhere near American Bar Endowment in terms of making profit. Do you recall their testimony?

A. I do, sir.

Q. Am I not correct then in the box that you drew on the board, association, credit cards, lenders, fictitious groups, the only entity that sits there, sits at the top of the



heep [sic], in fact is the heap [sic], is the American Bar Association? Isn't that correct? In terms of profit?

A. I think you just — when you went back over that group, you put in lenders and we talk about them separately. And when you put in associations you asked me about their testimony and I think you properly characterize their testimony. But if you look at an association and bring in the broker administrator, and look at some of the numbers that were entered into evidence by Mr. Steinig which showed the remuneration tables that New York Life uses, and they are one of the most cost-conscious controlling companies of all of them in this regard, you could see how the gross flow to an association or its broker administrator in terms of commission and allowance for expenses, could go to 35 percent on new business, or [3166] 34 percent on new business approximately, 20 percent on renewal business. And while that is only the gross, it is certainly more than the monies made on two or three of the ABE programs. So I don't think that you are completely out of striking distance. On the other hand, in saying that, I don't know enough about the facts of life of every association to make a definitive statement that there is nothing else like the ABE. I will say that I know of nothing as high and nothing has been brought into this record, excluding what happens in the case of title insurance and credit insurance, that shows those kind of rates of profitability per dollar of premium on at least two, maybe three of the plans.

Q. You have testified to three on Friday and this morning, did you not? And you testified over a ten-year period. You never addressed in this case the amount of profits made during the tax years in issue, have you? That is yes or no?

A. My testimony has never specifically addressed that.

Q. Because it is a lot higher than what Mr. Dennis represented whether he is correct or not, to be ten-year averages. Now, my question to you, sir, pointed you to the

box on associations. You answered [3167] the question by leaping out of the box and heading up to the broker administrator box.

As I understand your answer and as I listen to the expert witnesses of the United States of America, there is no other association, indeed there is no entity that any expert witness in this case can point to that makes anything resembling what you allege as profit by the American Bar Association at the expense of its members in this case; is that correct?

A. The last part of your question is correct if you limit yourself to associations and take out lenders and title operators president.

Q. I think your other experts have taken them out for you. All right, and you then point to the box broker administrator. You sat here and heard Mr. Gardner testify that leading broker administrators would knock on the door of the ABE to do a competitive bid on the cost plus basis for administration, did you not?

A. Yes, sir.

Q. And you know as well as I do that a cost-plus competitive bid is going to produce a miniscule profit if you assume ten capable agencies, each competing for this business and each wanting it, is that correct, as [3168] an economist?

A. Yes, sir.

\* \* \* \* \*

[3175] A. Yes, from the point of view of the individual consumer that is the only place where he can measure the retail cost to him, the cost to him at the retail level of the relevant insurance to contrast with the ABE offering.

Q. The employer-employee situation would be a wholesale situation?

A. Well, in general, the general thing is it doesn't cost the employee anything. Like in my case, I get it by virtue of being employed, though I get an extra layer on a con-

tributory basis but my employer is still paying for most of my total insurance protection. My quibble with that, and more my disagreement with the IRS is that when they go to look at how much it costs my employer they have a table rather than looking at how much it actually cost him. Administratively easier, unfortunately the table gives the wrong answer. But that is not relevant to what I would have to pay as an individual for insurance because I can't as an individual buy employee-employer group insurance.

I think I may have confused issues by [3176] bringing in the employer-employee group and the IRS. I just am angry at them for it. When my employer gives me \$1.00 in salary there is no question but that he has taken \$1.00 out of his pocket and given it to me and it is his cost of business. When he gives me insurance, in an environment where the value of the things he gives me for tax purposes are what it costs him, such as if he gives me a car, it is what the car cost him if I use it for private purposes.

The insurance I think is valued, ought to be and I think intended to be valued the same way, what did it cost the employer. The tables say look up on these tables and we will tell you what its value is in terms of what it costs, or presumed to have cost the employer. My observation is that presumption is off. It has gotten behind the times. It costs the employers a lot less than that table says. And again, I have been thinking about this outside and long before the occurrence of this case and talking with our group insurance administrator about that problem.

\* \* \* \* \*

[3188] THE WITNESS: Well—

THE COURT: By hypothesis, I mean.

THE WITNESS: I hear you. You say charged and I would ask charge to whom.

THE COURT: It always comes out of the insurance dollar, we know that. So we know it doesn't matter.

THE WITNESS: Well, in a sense I think it matters just because of the way you phrased it.

THE COURT: I was trying to plug into your terminology as best I could.

THE WITNESS: I think I understand what you are saying. What the ABE is doing is providing intermediation between the insurance carrier and a segment of the insurance-buying market. I think that everyone has more or less said that. In fact Dr. McGill—

[3189] THE COURT: I don't think it is disputed. I mean whether you use nicer terms—

THE WITNESS: Middleman may be disputed but intermediary is common vocabulary.

THE COURT: Very well.

THE WITNESS: What they are doing is not merely the, shall we say, ministerial and normal functions of general intermediation, which is checking off names and moving pieces of paper from here to there, or even the advertising function of some intermediation, but they are also—and with respect to their members they are uniquely capable of doing it—segregating a market, they are creating, making—I realize that became a disputed word so I tried to stay away from it, but they are identifying and segregating a for the insurance [*sic*].

\* \* \* \* \*

[3210] THE COURT: Let me ask you then the question I asked earlier. Does that make a difference in your view as to whether or not that turns out to be a competitive enterprise?

THE WITNESS: I gave you the "No" part of that. If you look just at the models I put on and my discussion of price, you could not distill the answer. But the answer to my mind, the full answer is yes. I did not speak to that because it was not the case here. And I believe as an economist we are dealing with rational persons. We used



to be able to say rational man, but now it is rational persons. And that a rational person would try to minimize his cost to the limits of his knowledge and convenience. And if at the checkout counter you are asked do you want to pay \$1.00 and get just the spaghetti, or do you want to pay \$1.25 and gets [*sic*] the spaghetti and credit in the world to come, you are making a separate decision to give to charity. You clearly are saying I can get this very precise good, this very insurance policy or this very box of spaghetti two ways, either I can buy the good alone or I can buy the good and at the same time give to charity and I have elected the second. And I would have no problem at all saying that any money flowing from the election is charity. Because I [3211] believe people try to minimize the cost they pay for a product, all other things being equal.

THE COURT: The fact that buying the box of spaghetti causes you not to buy somebody else's, the fact that maybe it has Mother Teresa's smiling face on it makes it more likely you are going to buy the spaghetti, the opportunity to make an easy charitable contribution steals away the customers from the poor Mueller Spaghetti Company?

THE WITNESS: Oh, I had not thought of that range of things, and yet I just don't feel at the margin they could make a difference. But when we are talking about the quarter that you either elect to pay or not pay, the additional quarter you elect to pay or not pay, to me that seems clearly like charity.

In fact I was thinking about it, maybe subconsciously in light of this case, though I was thinking about it just because it was a decision I recently had to make. American Express is saying every time you use their credit card to buy their travellers' checks they will give money to the Statue of Liberty. I recently took my sons to the statue of liberty so I have a greater affinity for her than I would ordinarily. I say that is nice.\* \* \*

\* \* \* \* \*

[3231] THE COURT: I was trying to get back to the point I had been discussing with you a little earlier. Basically there were two of them. One is the question of the free rider and the means by which one group—you understand by the way, I don't know if this has been explained to you, but this is not feeding-the-children-in-China insurance, this is insurance that benefits the ABE—

THE WITNESS: The program is benefited.

THE COURT: Lawyers, and society in a way that relates to lawyers. It is something that provides tangible, or intangible or indirect benefits [3232] to the legal profession.

THE WITNESS: Or allows lawyers to benefit society by bettering their profession.

THE COURT: Perhaps that is the way to say it. But I am wondering about the free rider problem and the ways of guarding against it, and whether in deciding to set up a charitable organization or charitable trust, a group such as a group of attorneys might not decide to overcome the free rider problem by causing a contribution whether implicit or explicit to be made by each of its members as one way of getting more people to share in the charitable aspects of the program.

THE WITNESS: One way of overcoming the free rider problem is saying I am going to give you something of value, the insurance product. And I am going to charge you a fair retail value for it. Now, I will admit, I could charge you less than that if I wanted to. But if you buy this at a fair value to you, you will also help me, and you will also help this greater good that I serve, and other people will also be motivated to do that. Not everyone, because they don't inconvenience themselves, they are still wholly rational economic men in making that decision.

THE COURT: And women, too.

[3233] THE WITNESS: Yes, men and women. But it would be a way of overcoming the pure free rider, that anyone in the program has gotten a fair value to begin



with, and then there is something extra added on, if you will. That would overcome part of the free rider problem.

The other point you bring up, which is one of great subtlety, is that the 80 percent who don't participate, and even some who do, have effectively given up the chance of the ABA to offer them the lowest possible group insurance rate, because that would kill off the ABE program.

So I must say I cannot take at face value the statement that the ABA offering the program would confuse the members. I don't think it would put confusion in the members' minds. What I do think it would do is kill the ABE program, but it would be an acid test of whether people are really motivated to give charity.

THE COURT: I guess I am asking do you think it would kill it because it would introduce the free rider program, because as things are now set up you are essentially forcing a contribution from everybody, thereby giving everybody an assurance others will contribute. If you have the purely voluntary [3234] situation would you not be introducing the free rider problem which applies to charitable endeavors as well as to anything else, thereby making it less likely that one person would contribute because he or she thinks that other people might not?

THE WITNESS: I think you might say that you would reintroduce a free rider problem. I think you have solved the free rider problem by giving the market value for the dollar paid, not the lowest price on the block but the market value for the dollar paid. You could reintroduce the free rider problem, but what you would then do is the person will say I will give charity with all the uncertainties usually attached to giving charity, which includes will the guy down the street also give to charity, would he be similarly motivated. If you had the choice of either the ABA offering the competitive program or the check off. Then you are right, you would reintroduce a free rider problem which you eliminated by giving the thing a value

to begin with. Don't you then put it on the same standing that almost all charities except what we give to the federal government stand on?

\* \* \* \* \*

[3278] THE COURT: Let me ask the question, and I really do want you to steer clear of answers that would jeopardize settlement on the one hand and anybody's position here on the other, but the two cases, the unrelated business case plus the deduction case go down the track parallel up to a point. But they do diverge. At some point they turn out to be different cases. And the question I have was are they so tied together in everyone's mind that they must be settled in a parallel fashion, or is there some way of settling the deduction case for percentage, or the unrelated business income case and let me decide the deduction; or indeed might it be possible to give up one for the other?

What I am saying is I am not sure if the consistency of resolution is necessary then in a merit determination, and certainly not in a settlement. I mean one could very well say this is not taxable to the Endowment but not deductible to the members, or conceivably one could work some other way. I am just throwing these out as possibilities for exploration if they have not been already.

[3279] MR. THROWER: I would say in response to that, Your Honor, that whatever settlement that was made in order to preserve the viability and credibility would have to be acceptable to the members who are participating. And I think it needs to be rationalized to 55,000 or 60,000 lawyers as to what is being done, and if it were rationalized we think we could do it. However, we think an irrational, factually irrational settlement would not be accepted, and therefore we could not accept a plan for the future in settlement that could not be rationalized when explained on the facts to the lawyers that are involved, and who will be asked to continue to participate in what we say is an essentially charitable program.

MR. GREGORY: Every time he says I have got 55,000 lawyers for clients, my back hurts more.

MR. THROWER: There is the very real possibility, as has been discussed, that the members having presented to them something that is irrational would prefer simply to terminate it all together, and that I think the evidence shows that choice is available every year.

THE COURT: Well, I am certainly not an expert in handling 55,000 lawyers, clients or whatever.

\* \* \* \* \*

[3375] Let me tell you the problem with Perimutter, if I could. Mr. Thrower reminds me, there is a failure of proof there. There is just no proof there as to the value of the financial benefit on the one hand and the value of the charitable contribution on the other. What we have here is a proven tax methodology for determining the value of the insurance coverage received by the member. And the excess amount being the dual payment for charity. And that is what the Tax Court is talking about at Perlmutter. They just can't separate out from the economic transaction the value of the zoning change and the value of the property.

THE COURT: Let me see if I can get you to come to grips head on with each other. What I think Mr. Dennis argument is going to be. I will do the same thing with him. Basically coming from the transaction at a different direction, you are looking at fair market value from the perspective of the organization, saying fair market value of a product is the cost of the product plus a little bit more. So recognizing for a minute the fact that this is an association, putting that aspect aside, and maybe that is a crucial distinction, but let's put that aspect aside for a minute; what your argument would be in [3376] that other context would be if you have a grocery store and it buys a loaf of bread at retail for \$1, the fair market value, the fair market retail value of that loaf of bread is \$1.25, because

25 cents markup is usual in the business. Or it would be something in that perspective.

Now, Mr. Dennis, if I understand it, would go around and look at what other loaves of breads are selling for and particularly how hungry you were for that particular loaf of bread and what would happen if you walked—say somebody walked up to you in the desert with that loaf of bread, you would be willing to pay more. Assuming you are in this market he would say what happens if you try to buy this same loaf of bread at Giant other than Safeway and he would say well Giant sells the loaf of bread for \$2 and therefore the fair market value of that is somewhere around \$2. Whereas, you would say the fair market value is something closer to \$1 or \$1.25. This is what you are both saying. I am wondering if you are going to kind of come to grips with the difference in perspective and why you are looking at the transaction in a different way.

MR. GREGORY: Because the authorities cited in our brief say what you value is what you get. And [3377] on your example—I am then going to give another example when we are finished with this particular dialogue, but in your example you have got to value what is the fair market value of that loaf of bread. In that case, presumably retail sale of that loaf of bread is the fair market value. What Mr. Dennis is telling you is “no, if only—this bread is sold only in this store at a certain price and that is the price the public buys it at, that is not how you value that bread.” If you can find in order to get the price up, which is what the Government is trying to do here, what you do is wander around town and look for a different product that will substitute in terms of your consumer needs and consumers desires for the loaf of bread that you can only buy in that store.

That is what the evidence in this case requires the Government to say. There is no other loaf of bread around town, in the insurance industry, in terms of the evidence in



this case. This is association group insurance, it is a specific animal and the case is dealing with the valuation of group insurance say you value that whether you can go out and replicate the purchase somewhere else or not. What you value is the cost. And I am trying to come to grips with what the Government is saying. If I [3378] miss your point —

THE COURT: Why is that? Actually I think I may have short changed the Government argument. One thing they are saying is you go around town and see what other loaves of bread are selling for. Maybe one can never find the exact same loaf of bread but we all value things by close analogy to other similar things. They may not be identical but you make adjustments for differences. The other thing it says is look — you then ask a thousand people what you would pay for this loaf of bread, what is it worth to you and they all say something like \$2. You know, I have looked around they say, and that is too much money to pay but you know, I really think in my heart that I ought to be able to pay less, but it is still the best deal I can get given all the other alternatives. And Mr. Burnett was that one thousand people, or one of those one thousand, or a representative sampling supposedly of people like that who say, "Well, this is the best insurance I can get. I am somewhat overweight, I am thought to be somewhat overweight so I have trouble getting insurance and this was the best deal in town for me. So to me the fair market value was what I actually paid."

What is wrong with that analysis?

[3379] MR. GREGORY: Nothing. He probably shouldn't take a deduction.

THE COURT: He didn't.

MR. GREGORY: Well, he probably shouldn't have.

Look, Your Honor, you have of course assumed in the question you put to me the distinction that is applicable to this case in terms of the American Bar Endowment and the

American Bar Association and its ability to replicate the group. That is why I did not respond on that basis. You said put aside the fact that this association, put aside the fact that this association could get it for \$1 for \$2 if it chose to do so. Indeed for \$2 instead.

THE COURT: No, we assume —

MR. GREGORY: Assume all the assured members participating in this plan can buy it for \$1, if this group chose to do so?

THE COURT: That is right. And we have assumed that the association can get it for \$1 in either case. Now, how much they charge the members or how much they require the members to pay for it, or how much they require the members to leave with them is a decision that they make —

MR. GREGORY: Except that the association is [3380] the members and the members are the association.

THE COURT: I want to get to that in a minute. I am wondering what, if this were a third party transaction — I want to focus on the associational aspects separately. What if this were a situation more like Disabled American Veterans where there were no sales to members, where the people who bought the product had only one choice; one choice, two options, and that is to buy the product at the price offered, or not buy it. And they have no control at all over the association to change its policies. What then would be the fair market value? How would you then determine the fair market value?

MR. GREGORY: Exactly like Disabled American Veterans tells you, and specifically in the discussion we just had about the decision. You have got to value that product. You have to determine under relevant tax principles — I have been very concerned in this case, that we have heard an awful lot over the weeks about economic principles, marketing principles, and very little about tax principles.



We are dealing with the Internal Revenue Code. That Code says that you value that product. And when you value that product you reach a \$1 result, as they did, as the Court did on the basis of the [3381] proof in Disabled American Veterans. They determined that there was a certain fair market value to the product, in this case the retail price, because that is the kind of product it was. Then amounts in excess of the retail price, in excess of the fair market value were not either—either were not income to Disabled American Veterans, where if they did it for two reasons, when it was sold much more than the retail price, the Court dismissed part of the case by saying you are not in a competitive commercial atmosphere and therefore, no income at all.

As to the second part, they said we are not so sure about the \$5 items, some are less, some may be five, some may be more, so in accordance with what at least I read in Footnote 19, the Court regarded as clearly analogous precedent, what you do is determine the value of the product in question and the charity takes in that amount as income, the value of the product in question. It doesn't take in the payment that it exacted, if you want, from the general population for sending them books, maps and charts in excess of what those books—not some other books, but those books and those charts and those maps can be bought for, what they have a retail value of, in that case the fair market value.

[3382] And we think that we have set forth in the brief by a discussion of the methodology for valuing group insurance—we are not writing on a clean slate here, we are writing by analogy to situations where an employee is given group insurance, which that employee has not got a chance in the world of replicating on the outside. You don't value the group insurance in those cases either under Section 61 or consistent with the principles of the Section

79 by hypothesizing the individual leaving the group, going down the block and trying to do his best to get \$100,000 of insurance coverage. That is just not the tax law.

What you value is how much did it cost to get that group insurance. And that, I think, is precisely what we are asking the Court to do here based upon the evidence in the case. And the evidence are dollars and cents. Member paid \$100, \$50 came back as a premium refund, kept by the Endowment pursuant to the assignment, \$10 were spent on expenses, we concede—as we have said all along that the member doesn't get a charitable deduction of 50 because the costs of running the group, and I guess including any reasonable profit if you want to say we are performing that kind of service, get deducted before the charitable contribution is figured. But he certainly [3383] gets the deduction for 40, just like the employee who cannot go out and get \$100,000 of insurance anywhere else only takes in the net cost of group insurance. The net cost of the employer-employee group.

THE COURT: I guess your point is regardless of whether to him that insurance is worth more or less?

MR. GREGORY: Well, let me—I don't want to turn the tables and be asking you questions, but I am not sure I know what you mean when you say with regard to that—

THE COURT: Well, say you have an employee with a bad health situation.

MR. GREGORY: No question that has absolutely nothing to do with it. You value the group insurance as the very nature of the group, that there are some people with bad health, as Mr. Barnhart kept wanting to talk about in his objective presentation, but the 60 percent of the populous [*sic*] that gets non-smokers' rates—and we didn't have that from Mr. Barnhart until we got to cross examination. But you don't take the smokers' rates into account. You don't look at each individual member of the

group and say what could you go get insurance for on your own because he would not be getting group insurance. You wouldn't be valuing group.

\* \* \* \* \*

[3457] THE COURT: No, no, no, this statement that a change to an independent insurance would not likely save you much money. I think that, at least as I interpret the statement, what Mr. Lashley is saying is if we did not run this as a charitable endeavor but we did it only for the benefit of the members you wouldn't save much money. Is that what you think he is saying?

MR. DENNIS: No.

THE COURT: What do you think?

MR. DENNIS: That if we gave the individual members an option of receiving the dividend or retrospective rate credit we wouldn't be fulfilling the functions of a section 5013 C organization, it has to be formed for the benefit of the public at large not for an individual member. And that is true of almost any of the —

THE COURT: Yes, yes, I believe you. Okay. So you say what I suggested earlier had happened, and that Mr. Murphy's request, or at Mr. Murphy's vote the plan were pulled out of the ABE, put into the ABA or some other non-C-3 type organization and from now on in rather than getting a little card in the mail saying congratulations, 40 percent of your dividend is now being contributed to charity you will get a check in [3458] the mail saying congratulations 40 percent of your dividend is hereby refunded to you in cash which you can spend to your heart's content.

Now, how can you tell me that would not save much money? 40 percent. I mean Mr. Lashley might have been saying that, but I disagree.

MR. DENNIS: Two points. What I understand Mr. Lashley to say in the letter is that "Mr. Murphy, you as an individual consumer in your position in the marketplace

you are not going to be able to save any money on any of the other —

THE COURT: No dispute on that, Mr. Dennis. Of course not. I mean the case is founded on that distinction. I mean we are not three weeks back, it is the end of the trial. There is no doubt at all that some consumers of insurance, perhaps many consumers of insurance could not independently get the benefit of the lower rates they could obtain through the ABE. That is precisely correct. Nobody disputes that.

I thought Mr. Lashley was addressing something else.

MR. DENNIS: I don't see him as saying that when he says independent insurance program. I read him as saying alternatives in the marketplace.

THE COURT: Well, in that case I beg to — I [3459] take back whatever I might have said about Mr. Lashley puffing. Of course that is true but trivial. How does that respond to the question I posed to you, which is what would happen were the ABE plan changed to be operated on a service basis. And what effect does the ability of Mr. Murphy and others to make that change have upon the consideration of this case.

MR. DENNIS: As we read the case law, Your Honor, a (c)(6) organization cannot be formed to provide benefits, low-cost insurance, to members either. That no matter what type —

THE COURT: You think that a specific answer to what I had asked is that if the ABA assembly decided to pull the plan from the ABE and run it itself, the American Bar Endowment decides to run the plan itself on entirely a service basis that that would be illegal or in contravention of the law?

MR. DENNIS: I don't know about illegal, simply they were formed for public purposes —

THE COURT: Would they lose the (c)(6) status? Isn't ABA 6?



MR. DENNIS: Yes.

THE COURT: Would they lose the (c)(6) status, would the wrath of the Lord fall upon then, would anything terrible happen?

[3460] MR. DENNIS: All I can say is there is a number of cases under (c)(6) —

THE COURT: You know or you don't know?

MR. DENNIS: I don't know. I think it would be in jeopardy.

THE COURT: What about the plan of the American Medical Association or American Psychiatric Association?

MR. DENNIS: I understand that the AMA—I don't know the facts. I have heard they are not an exempt organization. I could be mistaken but I hear they want to provide low-cost insurance.

THE COURT: How about the New York State Bar plan, does that place the New York State Bar in jeopardy of losing whatever status it has as I assume an exempt organization?

MR. DENNIS: I don't know the section they are exempt under. And I don't know the facts of their case.

THE COURT: We may not have a difference in law. At least I don't know the answer as to whether moving the plan into the ABA would place the ABA's tax status in jeopardy. I guess you are not able to tell me.

Let me ask Mr. Gregory as to whether he [3461] shares those doubts because I would like to identify any unresolved questions of law.

MR. GREGORY: Depends what you mean by doubts. There is no question in the world that the ABA could run this insurance plan as a service to members. Let me let Mr. Thrower respond.

THE COURT: I simply want to see whether there is a difference of opinion on this.

MR. GREGORY: Well, let me say that I think the tax lawyer ought to respond to that directly. Mr. Thrower just knows more about how to answer this question than I do. I would like him to answer.

THE COURT: I really wasn't looking for an answer, merely —

MR. THROWER: Well, Your Honor, I think in a nutshell if those services are incidental to its total services rather than its sole activity there would be no question about it. I think the evidence has shown that almost all of the state bars in the country do this, and many local Bar associations. And the Philadelphia Bar association.

\* \* \* \* \*

[3532] THE COURT: [If you] are talking about New York and adopt Mr. Gregory's test, or if you are talking about New York and adopt your test, you really have somebody who has a clear option, much cheaper insurance, goes and buys ABA, if you really look at that person's situation—I don't want to put words in your mouth or certainly not any admissions, but I think if we sit it on the table, we say that person probably was making a contribution and the fair value of that insurance is certainly in more than getting the very same insurance from the New York State Bar and I am going to put aside the differences as to whether New York Life Insurance provided by the state Bar or by the ABA is a little bit better or little worse. I just think the distinctions are silly. I mean I have heard what they are and I don't just think they are very important.

So it seems to me that anybody in New York State who buys ABA insurance is going to be making a contribution, unless they are really misinformed, and I am not going to presume lawyers are misinformed when it comes to bucks. It is just not my usual experience.



And then we get the lawyer in Oklahoma, or Louisiana, or Podunk and it is very much more likely—or where Mr. Burnett came from, Arkansas, where it was quite clear to me he grabbed the best deal he could.

\* \* \* \* \*

[3536] THE COURT: Okay, thank you very much. I am going to take a little break and come back with as much of a decision or perhaps an entire decision, as I can make today.

(A brief recess was taken.)

THE COURT: Please be seated.

I am going to decide Case Number 465-82T, the case of the American Bar Endowment versus the United States, in favor of the American Bar Endowment, the plaintiff.

I have sat through three and a half weeks of trial, and have had an ample opportunity to observe witnesses, and to absorb their testimony and I have looked at as many documents as I think could profitability [*sic*] be looked at. And the reason I am deciding that case in favor of the American Bar Endowment is that I have determined that this is not a business and is not making a profit from its enterprise.

Now, Dr. Plotkin suggested several smell [3537] tests that can be employed for that purpose, and I suppose I have used my own smell test as well as the facts.

The first factor, and one which ought not to be at all underestimated in importance, is the way the program is billed, the way it is advertised, the way it is presented, the way it is operated. The program is presented to the world and to the members in a very open fashion, as a charitable program, as a means of fundraising.

That is not determinative. The fact that the program either through subterfuge or through perhaps honest delusion is presented as a fundraising effort or the means to raise charitable funds, is not conclusive, is not binding on the Court; but I certainly think it is well worth considering as one factor.

I may be less skeptical than my brothers and sisters in the field of taxation law, but to me what people say to each other, particularly when large groups of people say it repeatedly to each other and they have a common understanding, makes a difference, makes a starting point. It raises a presumption. Perhaps not a very strong presumption, but one that I think is well worth keeping in mind as a place from [3538] which to depart.

Now, in this case we have seen a good deal of advertising and a good deal of literature, a good deal of promotional materials, ABA journal articles, reports, so on, and I find that it was made abundantly clear to the ABA membership and the ABE membership that the insurance programs were a method for fundraising. That was billed as its purpose, and this was communicated in fact to the membership; and one, of course, can never guarantee in a group of 300,000 that each and every member will unmistakably learn the precise purpose, but I find that with perhaps trivial examples, lawyers being well informed, certainly being able to read, and there was a barrage of literature, barrage of advertising, barrage of reports which over the years should have made it abundantly clear and did make it quite clear that was the billed purpose, that was the way the program was perceived.

I also look in the smell-test category, rather than necessarily the operative fact—and it is a gray area as to where one begins and the other one ends, but I also look at the startling profitability of this group. And it has made a lot of money over the years, it has made \$63 million. That tells me two things. One of them is there was a lot [3539] of testimony about who else in this general type of enterprise or in this general field has made, or will make or can have made this much of a profit, and I think the evidence is quite clear, and in any case I so find that equivalent profits were only made by what has been described by one witness as the robber scoundrels of the insurance industry

who, as I understood Ms. Khachadour and other witnesses to explain, used captive audiences, used very serious pressure tactics, used practices that can be viewed as entirely—or could be viewed certainly and have been viewed as unethical and have been made unlawful; such things as a person who wants to get a loan, who may be desperate for a loan, maybe something having to do with his house or who may need the loan for some other personal purpose and may be required as a condition for buying the loan to buy the insurance.

The analogy to those kinds of situations, or to that kind of an enterprise is nonexistent here. To be sure, the American Bar Endowment used advertising and something that conceivably could be viewed as scare tactics, listing the many illnesses that befall man in light of his transgression many years ago with the apple and the snake; and I suppose that is our lot, we have frail bodies and once in a while we do get [3540] reminded of the fact that the unfortunate among us can be beset with illness and death.

But that is an entirely different kind of pressure tactic than holding the necessity of a completely collateral nature, such as a loan, car or house loan, or some other transaction, hostage to the purchase of insurance.

So when we look at the question of these great tremendous profits, we have to find some other explanation as to why this particular operation has been so successful in raising funds, and once again here I reveal my lack of skepticism, perhaps, but my feeling is that the obvious explanation sometimes is the one that is correct. You know, if it looks like a duck and quacks like a duck, and you know it leaves droppings on the floor like a duck, then maybe it is a duck. And in this case the explanation that suggests itself to the mind immediately, if indeed the American Bar Endowment were selling its members—"selling," I use loosely the term, was conveying the idea

that this was a fundraising enterprise and therefore rates are going to be set in accordance therewith, and that the many millions of dollars that were made from this enterprise were disclosed to the members over the years, and the profitability of the enterprise [3541] continued, the suggestion is that maybe members really thought this was a fundraising enterprise, that they were really participating in fundraising and that they tolerated this as consistent with the purpose of the effort.

This is certainly the suggestion that arises in one's minds when one looks at these factors. Nothing I have seen in this case suggests that that is different. I think it is almost bizarre to suggest that the strong fundraising aspect of the literature and of the approach, of the information conveyed, the fact that the profits, as they are called, or the result of all of these fundraising activities were disclosed and, so to speak, rubbed into the faces of the members, that it would be ignored, that it doesn't exist in reality? I simply have seen nothing in this case that suggests that those factors ought to be not taken into account.

Now, what have we got here? When I started to analyze it, I posed it as hypothesis at various times in the trial, but now I will state it as my finding: I think we have a situation here where there is a group asset. There is an asset that exists only by virtue of the group.

An individual member does not have a piece [3542] of the asset in the sense that he could walk away and pocket it and use it on his own. By virtue of existing as part of a group something more is created, an economic good is created which did not exist outside the group experience. And I am not sure how to characterize this asset or what I ought to call it, but we all know, all of us who have sat here and watched for the last several weeks know the nature of the beast. It is a favorable group rating. It is the ability to bargain well with the insurance company and to get the discounts that go with being an experience rated group.



It has been described in various ways, but what it amounts to is a reality that seems to be, at least as far as this record is concerned, limited to the insurance industry. I don't say some other case might not arise that might involve a similar analogous experience in some other industry, but nothing suggests itself to the mind.

The asset is created by virtue of the fact that it is possible, or so we have learned, to segregate out of the mass marketing of insurance a group that has more favorable morbidity and mortality experience; that enables that group and its members by virtue of group membership to profit from lower rates. [3543] Or they could profit from lower rates if they don't do something to stop themselves from so profiting.

And that raising [*sic*] interesting questions. I wish I had had economists to discuss with me—because I am not sure anybody else here likes economists. I know Mr. Gregory is skeptical of them, but I for one enjoy listening to economists and I frequently learn. And what was somewhat lacking on this record, and what I had to to some extent use my own imagination for is the economics of the group asset. How does one create a group asset, how does one control a group asset, how does one monetize a group asset and the various aspects of group ownership, control and distribution of whatever benefits are involved.

And absent evidence to the contrary it seems to me that an asset that is created by virtue of the existence of the group ought to belong to the group and not to any one individual member, that it is something that the group as a whole must dispose of through normal group processes. It is not, as I said, the type of asset that could be divided up and allow each person to walk away with it, it has to be dealt with in some group fashion, left to be dissipated. It seems to me group processes normally rule by majority [3544] and when the group is too large to have absolute majority rule the representative process is the way to dispose of group assets.

To be sure there are always in the group, as there is in society, those who would deal with group problems in a fashion which is different from the majority. That is the nature of the democratic process and that is the nature of the group process. Any group larger than one has a potential for dissidence. And I don't know what one can do about it. We are all a part of groups and societies; and I don't think there is anybody here who agrees with everything our Government does in every instance, nevertheless it is our Government and it has imputed to us our action, and by the same token the group asset is disposed of by the group. In this case the group has made a decision through its membership, or its leadership to dedicate and devote the group assets for a charitable purpose. And they have chosen a way which in my view is calculated to achieve that result. And by donating the asset in total to the American Bar Endowment and allowing for it to monetize it, to in some fashion derive from this asset the most benefit that it can for the charitable enterprise.

Now, it should be observed, and I think Dr. [3545] Plotkin agreed with me on this, from an economic standpoint the membership by making the decision has uniformly to a person made a contribution in an economic sense; by voting for this group device, for this disposition of the group asset, each and every member has been deprived of the opportunity to participate in a lower-cost insurance program, if indeed the American Bar Endowment were able to set one up.

Now, there have been some last-minute questions raised on that, and I simply cannot believe that after all of the evidence we have seen in this trial about state bars and local bars and county bars setting up group plans that there would be serious question that if the ABA membership with all of the legal talent at its disposal chose to set up a plan that would be simply a service-oriented plan that



they could not figure out some way of doing it without losing the tax status of either the ABE or ABA or both.

Now, by making the decision, each and every member is contributing to the joint enterprise by agreeing to forgo the benefits, and they have been pointed out to be substantial benefits, of the much lower service-oriented group insurance.

The question then arises to what degree is [3546] there really control over the group. By the group rather, I mean over the program. And that has been raised as an issue. And I simply have seen no evidence at all suggesting that this group is any different from any other group in the ability of members to make their views known to the leadership, and to change the direction taken by the leadership when it is inimical to their understanding and interest.

I said I would take judicial notice of the events that transpired in the D.C. Bar several years ago, and in that case there was a great rift between the leadership of the Bar and the rank and file. There is great evidence that the D.C. Bar thought that the two referendums that were posed, one which would lower dues on the one hand and the other which would limit activities to the Bar, would sound the death knell to the Bar as an institution, that it would render it merely a shadow of its former self, that it was the professional responsibility to engage in other activities, that this was generally a bad idea.

There was no doubt to those of us who are in D.C., certainly not to me when I was here when this was going on, and certainly the materials don't raise [3547] any doubt, but that this was a grass roots movement versus leadership of the Bar. And when all was said and done, and when it came down to the economic interests of the Bar members and the few dollars here and the few dollars there, and the dust settled, the members of the Bar spoke loud and clear: They preferred to keep the money themselves rather than engaging in various extraneous Bar-type activities, other

than the minimal ones of attorney discipline and the like. D.C. members simply did not want their Bar squandering their money, or at least they viewed it as squandering their money on public spirited types of activities, activities that would enhance the organization.

I have little reason to believe that when \$63 million are at stake that the members of the American Bar Association or the American Bar Endowment could not change that policy. Now, again I want to point out that more than \$63 million are at stake, because not only is at stake the amount that was actually collected in dividends and premium refunds, but one must also include the economic incentives and the economic benefits lost, all of the benefits that other members of the Bar who chose not to participate in insurance would have gained if only there were a [3548] change in the policy. So we are not talking only about those who buy the insurance and forgo the premiums, but we are also talking about the significant economic incentives that exist for those who do not buy the insurance but wish they could.

I am persuaded that if the American Bar Association Plan were not viewed as a fundraising enterprise and were not viewed by the overwhelming majority of the membership as something to be tolerated as, to be sure, an economic expense but one for the good of the profession, and for the greater good of society, that it would not exist, it could not have existed, it could not have survived, it would not have survived to today. And at least on the basis of this record those are my findings on that point.

I do want to speak a little about the analysis of Dr. Plotkin, whom I certainly enjoyed hearing, and for whom I have a great deal of respect. I questioned him at some length because—well, I couldn't forego the opportunity, and because I guess I had questions that went to the heart of his analysis, or to the manner in which his analysis was constructed, and I wanted to understand what direction he came from.

Now, Dr. Plotkin was quite candid that the analysis that he employed was an industrial [3549] organization analysis. It was analysis born of antitrust. Much time is spent by economists wondering whether if one fixes prices everyone will be better or worse off, and as I recall by way of showing on that board—I am sure Mr. Gregory would want to know precisely how that is done—that if you only avoid price fixing there will be more things for more people, and things get more complex from there.

The question I asked myself is how do the underpinnings of industrial organization analysis, antitrust analysis, relate to the question in this case. And the question in this case is a rather more narrow one. We are not dealing with the broad questions of antitrust, those questions involve very complex issues and very complex policy judgments. We are here dealing with basically the question of whether something is a business or is not a business, whether something is a fundraising activities or not a fundraising activity. We are looking to indices, but by definition that activity has to take place in the market.

And by definition, again from Dr. Plotkin's own statements, that activity, fundraising activity, must displace and must have a ripple effect upon the market in which it operates. It is almost [3550] inconceivable to have some activity that one could classify as simply fundraising that does not somehow effect other transactions in the market and other various structures of the marketplace. And I was interested to find out how those policies, how the things that Dr. Plotkin was taking into account in reaching his conclusion related to what we are talking about here.

I was a little disappointed to understand that Dr. Plotkin, while he was conversant with spaghetti—which is fine, which is really the place where the unrelated business income tax started from—was not as conversant as I well might have hoped with the policies of the unrelated

business income tax. To him the fact that if one buys one brand of spaghetti one is less likely to buy another one seemed to be—I don't mean to give too little weight to his testimony, but simply that seemed to be the key for him, a question of substitution in the market. And this is simply not the way I viewed the unrelated business income tax and that is not the way I viewed the Disabled American Veterans.

The unrelated business income tax was passed to avoid a certain kind of evil. Now, we all know that one cannot use and ought not use, and I certainly [3551] will not use legislative history to go contrary to the express terms of a statute when they are clearly applicable to a situation. But Congress was not so generous in defining for us business profit and the like. We have to make the decisions on our own, we the courts. And therefore in looking at a situation where you have a transaction where both buyer and seller are consenting in the sense that one controls the other, or one has significant control over the other, one is somewhat at a loss to see whether something is a profit. That is what we have been grappling with here for the last three weeks. So you go back and look at what evil there is in the market. What was Congress trying to do in 1950 or 1953 or when the uniform business income tax was passed, and one comes to the frequently-asked question, "Who is Ronzoni."

Now, nobody has really satisfactorily pointed to Ronzoni for me. I have been listening for three weeks of trial and nobody came up and said, "Here, this is Ronzoni, this is the competitor that is going to be adversely affected in the manner in which Congress feared there would be adverse effects when it slapped Mueller Macaroni Company on the wrist, or basically said you cannot do that, you cannot use your [3552] tax exempt status to make profits.



And I am still somewhat nebulous as to who Ronzoni is, as to who is hurt, who is damaged if the members of the association on the one hand allow the association to use its group asset in order to raise funds. And I don't think — you know, the most obvious Ronzonis, or the most obvious candidates are the other life insurance companies, your Prudentials, your Mutuals of New York, and the like. And all the evidence seems to be that if only ABE charged less, if only ABE charged less and perhaps charged so little as to make no return or profit or whatever one calls it, fundraising, at all, there will be more people buying ABE insurance, for many people that would then become a better deal and it would be more likely that Prudential Insurance and Mutual of New York and the like would lose business.

So in that respect the results suggested here by application of the tax at least initially looks like a perverse result. But when one thinks out loud, what else is there? I mean is there some other organization in the market, some other Ronzoni, some other enterprise that is damaged, hurt, that suffers by virtue of the fact that this charitable type enterprise in engaging in this activity. Is the evil [3553] the Congress sought to alleviate creeping in in some fashion which is not obvious to the naked eye. And it takes another look.

And the question then is what of the organization as an intermediary, or as somebody who goes and sells the group experience for insurance companies, or somehow competing perhaps with other people who would act as intermediaries to this group, or something of that sort.

And the evidence tends to strike a couple of these hypotheses out right away. All of the evidence on both sides makes it clear that the money here came from premiums, that no matter what the flow of dollars the economic reality was that these were the members paying money to the association and not insurance companies paying the group in some fashion. The evidence of the in-

surance people was clear, but more telling was the undisputed evidence of all of the other witnesses, Ms. Khachadour as I recall was one of them; and quite clearly insurance companies don't manufacture money, although some of us may suspect at times they do; it comes from premiums.

I don't think this is a terribly complicated transaction, I think most people know what dividends are and that basically they come from refund of the [3554] premium and the premium came from the member. So it is difficult to construct a hypothesis that somehow the group is selling something to the insurance companies.

And you get back to the question is the group profiting from its own members. And I simply was not able to find that it is. I find that the idea of profiting from oneself, that the idea that profit given by consent, is almost a contradiction in terms.

Now, could somebody else have stepped in, or is ABE precluding somebody from stepping in and taking advantage of some market opportunities, the sellers of macaroni, some sort of analogy of that sort?

The point is there is only one such group asset, only one group experience. It belongs to the group. I have seen no reason to think that it belongs to society as a whole or to individual members; nothing has been presented to suggest that it ought to belong to anybody but the group. And this situation is not like the purchase of macaroni, where basically only one entity can have the benefit of that and the group has chosen to make a gift of that group asset to the Endowment. And you know, perhaps other witnesses and other economists, on a different record, somebody will be able to point out to me Ronzoni in this [3555] picture, but I have tried very hard, and looking at the policies of the tax, the policies of the unrelated business income tax, I have not been able to find the evils that Congress sought to alleviate by passing that tax.



Therefore getting back to the analysis itself, there is nothing that would push back the original inclination I had, this is billed as a charitable enterprise, it is presented as a charitable enterprise, it is a group asset, it is given by mutual consent, members have control, one can't make a profit on oneself, I don't think. I think it is the antithesis of a profit to say that one can have control of how much profit we take, much like the suggestion I made to Mr. Dennis what would happen if all Safeway customers were allowed to vote on the prices at Safeway. The reason Safeway makes a profit is because customers don't get a chance to vote. And I therefore conclude that it is just not a business enterprise, by its structure, by the way it is operated, by the way it is billed and by the reference to the policies of the tax, there was not profit and therefore not a business.

I have considerably greater trouble on the issue of the individual members, and as clear in my [3556] mind as the issue of the Endowment is, or at least the way it seems to me it is clear, I have still grave doubts on the question of the individual members, and I am not going to be able to resolve them today.

I have listened to both sides, I have listened to both sides speak today, and perhaps the problem is the case has been tried and presented and certainly viewed by me largely with reference to the unrelated business income tax, to that aspect of the transaction, and in the fond hope that that would take care of the other problem as well. And in Plaintiff's view I know that it does. In Defendant's view I think, had the result been different on the Endowment case, I am sure they would have had the same view. I view them as not necessarily related. I recognize that is a much more difficult problem and one that I just cannot resolve today. I am simply going to have to go back and think about it.

I understand very well where the two parties are coming from. I think I understand this case as well as anybody here, because I have the benefit of not having the perspective of one party or another. And Plaintiff is saying the valuation of insurance to a group ought to be the net cost. That is a fair market value.

[3557] I understand Defendant's position equally well, that one looks at comparable sales and comparable transactions and that you don't look at cost of the product to determine its value. One can get into a bargain and buy something one day, buy a stock one day, say, and then it gets taken over, or there is an offering by some other company to buy out that stock and it immediately shoots up. Well, the fair market value of the stock is not necessarily what one paid for it the day before, it is what somebody else was willing to buy it for today. Those who have bought and sold on the stock market know that. I think there are inherent and difficult inconsistencies that cannot be resolved by either position and that may be unresolvable.

I recognize that the Government has done away with, or has never really quite presented the Duberstein test; and the question is not one of good heart or generosity, but I am troubled by the position taken by the Plaintiff in offering Mr. Burnett a charitable contribution. I may decide that nevertheless Mr. Burnett ought to get one, but having seen him sitting on the stand, and being convinced that he in fact bought the insurance because it was the best deal he had, I am troubled about saying that [3558] he ought to get a charitable deduction on top of everything. I simply am convinced as to him that he is buying the insurance by virtue of the fact that it is the best deal and not because he has any attachment to the Endowment's purposes or otherwise.

I am equally troubled by the position taken by the Defendant, the suggestion that these are name tags, or books or key chains capable of valuation in one market is

simply not supported by this record. I think it is utter nonsense. I think there are at least 50 markets for insurance, particularly group insurance. I think one ought to take into account the basic and significant differences between group insurance and individual insurance. I think individual insurance by clearly established record is a different product, and a significantly different product. One can take it with one to one's grave or something of that sort. Certainly to California. And it is viewed, sold, marketed and considered as a different product. There are little frills you can buy with it. You can buy double indemnity and accidental death, waiver of premium; you can insure your insurability. It is yours, you can do lots of things with it. I think the subjective valuation that people place on having an insurance plan is not [3559] dominant upon a membership to an organization or that it is somehow geographically limited.

So comparison with individual insurance, although not entirely irrelevant, I think is inherently misleading, and it is very difficult to account for the subjective differences that a particular consumer of insurance would feel in having his own insurance that can't be taken away from him, that has guaranteed premiums as opposed to another insurance where he has to pay membership in an organization that may or may not exist, that may or may not expel him, that may or may not be acting in his best interest, that may or may not be in the same geographic area all the time; let's say he has to move overseas or elsewhere, there are many uncertainties connected with group insurance which are simply not present to individual insurance and I find the analogy on them on the basis of this records [sic] to be a difficult one. I don't find them incompatible, entirely irrelevant, but on the spectrum of things individual insurance is much further away from center than let's say other Bar plans or other associational insurance available.

Nevertheless the point is well taken. The market consists of lots of competing products and many [3560] of them are only imperfect substitutes for another, and yet for better or worse courts must consistently make decisions on the basis of somewhat arbitrary distinctions between valuations of one item or another; the house near the end of the block as opposed to the one in the middle of the block, the house two blocks away closer to the supermarket and across the street from the school. Courts do it all the time.

What is troubling about Defendants [sic] analysis is not the idea that one ought to value some very, very subjective considerations one against the other, but the idea that there is one market, and the idea that one can find a fair market value for insurance in the United States and place the American Bar Endowment plan either within or without that market range. And that is very troubling.

I am troubled by the gentleman or lady in New York City who is a member of those two associations and who has by hypothesis in front of himself or herself the two plans, the New York State plan and the American Bar Association Plan. I cannot on the basis of this record—I could not conclude for such individual if he or she were to come to ask for a refund in this Court and I would look at that person's situation that a decision to buy American Bar [3561] Endowment insurance is other than a gift, that it was a contribution, that it was indeed the differential was paid in order not to get insurance, but in order to get whatever satisfaction one gets from contributing.

There are the two positions. Both create unfairnesses and both create what I view as inconsistencies. And I know both sides feel that their view of the transaction is the only one that is acceptable. I am simply saying I am enough troubled about it that I am not going to decide today. And I am going to say this much: I am not simply withholding this issue, but I am indeed undecided. I am so close to 50-50 on this issue that I cannot personally myself



tell which way I would decide the case were I to make a decision at this minute. I would probably have to throw up a coin or something close to that. I don't know if that is any help to anybody. It is not nearly as much help as getting the case decided in one's favor, but there it is.

I am fairly firm, quite firm on the Endowment side of the case. As I have said before, I consider myself infallible although not irreversible, so I think everybody should have the hope, or the appropriate amount of skepticism. [3562] I want to suggest to the parties further possibilities of settlement. I had hinted at this before today's session. I want to now propose it outright. On the one hand, I think there are basics for settling. Nobody really knows, including myself, how I am going to come out on the members. At least Mr. Rubloff empathizes with my dilemma and I hope others too. I will decide it, one way or another I will come out with it, and if nobody suggests the middle way I will have to select one of the two positions suggested, and in light of my ruling on the other case I am going to have to go back and rethink and look at the authorities cited one more time. And I figured the first case out and I will figure this one out too for better or worse, but let me suggest the possibility that settlement may not still be beyond reach.

I have made my statement on the Endowment's case. And one should not underestimate the deference that an Appellate Court will give to a trial Judge who has sat here for three and a half weeks and looked at the witnesses and considered the evidence.

On the other hand, these are big issues. And by everybody's analysis there is really not that much in dispute. If the parties after all of this [3563] want to sit down and hammer out a stipulation, I bet you it could be done. So nobody is really going to offer me the kind of deference in a case where there are two inconsistent

witnesses, one says I was home with my mother and the other says I saw them stabbing the victim. It is just not that kind of case.

I will endeavor as best I can to pull together the relevant facts as I see them, but my opinions tend to be short on facts. I tend to say only the things that I consider relevant or crucial to my decision, and I think it is fair to say that the Appellate Court will be able to make up its own mind on the analysis, the analytical portion of my conclusion. So whereas I think there is good reason for the Bar Endowment and its members insofar as the Endowment to be heartened by my decision, there is always the possibility of reversal, and I guess I don't need to repeat that again. I think it ought to be on everybody's mind.

And then there is the question of how I am going to come out on the individual members. I have no way of knowing what is really important to the parties and what is really the telling aspects of the case, whether the members' case is more important than the Endowment case or the like. This is only [3564] something that each side can determine on its own.

But as far as the Government is concerned, I promise at least as far as the Endowment is concerned, and certainly whatever I do with the members, I will write an opinion that I hope is persuasive. I will, having once decided how the case ought to appear, I will draft it in such a manner as to maximize the chances for affirmance. Let me just say there is certainly solace to be taken from the possibility of reversal, but I wouldn't count on it. I think more likely than not appellate courts in such cases tend to give some deference.

I am going to think about this case. I have about seven trials coming up, five before the first of the year, a couple more in January, and I have three major opinions in the works. Frankly, I have spent enough time on tax for a while, and particularly on the American Bar Endowment.



I am going to another trial starting Tuesday. I have got speaking engagements and trials in Houston and Lord knows. I have got a trial starting between Christmas and New Year's. So I would just as soon not think about this case for a while. And in light of all that you have learned today, and perhaps for the first time you have now had your respective views scrutinized by somebody [3565] I hope you understand understands what you all have to say. You may not all agree with everything I said, in fact I am sure each side disagrees with some of what I said, but I do understand your case and I do in light of the maximum amount of evidence that has been presented I think have a pretty good grasp of what went on.

So try to step back from your own position, from your own view of the case and kind of view it from my perspective, and then ask yourself is there a basis for trying to work out on the one hand securing the gains already made, and on the other hand salvaging the limiting losses that might already have been suffered.

So I think you should all go home, digest it, buy the record, buy a transcript, listen carefully to what I was saying, what I was asking, what I said this afternoon, and try to figure out how I am going to decide the other aspect of the case. And if you can, you are more clairvoyant than I am. But what I propose to do is take a little while off and work on some other cases. I simply do not at this point have the time to devote further to this case and I am going to leave it in abeyance. The other cases are lined up. And I do want to give everybody a chance to have [3566] things sink in and I would then like to request one more massive and good faith effort at settlement.

What I have said today on the record is not necessarily of precedential value. My thoughts are in the transcript. They do not embody an opinion. They are known to those present, but of course they would not be binding on anybody else. Think of the consequences of an opinion,

the consequences of affirmance or reversal of the opinion, and think about the one outstanding issue; and do not minimize how difficult an issue it is. Much as everybody thinks that they are right on it, I think you fairly ought to know I am not doing this in order to in a sense extort a settlement. If I could have decided the case in its entirety today I would be entirely pleased to do so. I am not holding back just to press settlement. I simply cannot decide it today. It is unusual for me, but I always reserve that prerogative, and when important cases come along and difficult issues, issues I cannot resolve on the spot, I want to be as candid about that as I am about telling you when I have made up my mind.

Why don't we set the case for status in about three weeks?

MR. GREGORY: I take it, Your Honor, that [3567] with four remaining cases of the individuals, you are not deciding either the New York Plaintiff cases today or the other cases?

THE COURT: I am deciding the Bar Endowment case. I am not deciding any of the individual cases. Now, in a sense there is no decision today, and there is no opinion or judgment or order or anything of that sort. I have simply made the prediction of what my opinion is going to read like. I am not going to change my mind. My mind may be changed for me but I am not going to change my mind on that one. In a sense what I was telling you is what my mind looks like at this point and I have decided in my mind the Bar Endowment case, and I will eventually have an opinion that reflects many of the thoughts I gave today orally.

I am not deciding any of the individual cases. I don't think they can be separated, Georgia, New York, though perhaps it can be, perhaps what we wind up with is some geographical nightmare where people from New York are going to be better off than people from Arkansas. I would

hope that is not the result I come up with. I would hope fervently that everybody thinks about the mischief that judges can do when they start trying to work their way out of what [3568] they consider to be difficult theoretical boxes, or difficult dilemmas.

I want to be candid, this is a dilemma for me. I find that aspect of the case the most difficult part. Everything else, judgment calls, whatever, but it finally fell into place for me. I see my way clear quite well on the Endowment. It just has not fallen into place for me as far as the members are concerned. Please don't make me make any mischief. We want the law to develop in a reasonable fashion. And consider your respective interest, consider what you think you can give up, take into account what I have said and the consequences of the ruling in this case to yourselves, to the law as a whole, to other taxpayers.

It is never too late to settle. I suppose it is too late to settle once cert is denied, but should we set—can I get the agreement of both sides you will go back, digest what I have said and make one final very serious stab at settlement?

MR. THROWER: Your Honor, I can assure you we will take seriously and to heart the remarks that you have made. We will make an earnest effort in the light of what has been said here this afternoon. I do know that time is required on the other side to absorb and reflect and react.

\* \* \* \* \*

[3581] As usual, if you get lawyers involved performing tasks it costs them money. We made a submission. If I understand the present position, and I want to make it clear on the record, because if this case is to have a future history I know the Board will be concerned about it.

Apparently the position of the Government is that we would be free, as Mr. Thrower put it, to continue to put in offers of settlement more and more liberal until one is ac-

cepted. It would be our position, if that is the Government's position, that we would have to advise the client that that would not be a fruitful way of going, and that on that basis I would concur in the Court's statement that the parties would agree that there fruitful possibility of settlement [sic].

That concurrence is specifically founded upon what I hear to be the suggestion of The United States, namely, that we can keep putting in offers and we're not going to get any counter-offers.

THE COURT: So be it. I will just decide the case. Now, I'm not going to have the judgment for you until well into February. In light of what my findings and my tentative conclusions are the sides can do—you know, I'm disappointed in the fact that there has been no settlement, but I have no doubt that much thought has been given, and that without knowing anything about the settlement—and I assure you, Judge Margolis [3582] has been very circumspect, has told me nothing at all about the settlement—assuming, because I know counsel from the case and otherwise that it has been in good faith on all sides.

I guess there wouldn't be any call for judges if all the litigants could agree with each other as to how they come out.

Very well. I found this to be,—first of all, I have good news and bad news. It depends on which side. I have given more thought about the part of the case, the American Bar Endowment part of the case, the part that I had decided at the time of the last meeting, and I am pleased to say I haven't changed my mind.

I feel entirely comfortable with the result, and I can tell you now with a fair degree of certainty that that is how it will, in fact, come out in my opinion. I have not started working on the opinion, but once in awhile one makes an oral ruling and is troubled by it, and looks for ways of stepping back or anything of that sort, so I will not be stepping back from what I said the last time we met.



I may be wrong, but I am happily so. I hope I'm right. I do continue in my conclusion that —

MR. RUBLOFF: Your Honor, could I inquire of the Court as to whether any findings of fact, specific findings of fact will be made?

THE COURT: Probably not. You can pick them out of [3583] what I said in my opinion. I don't think I will make specific findings. Is there something specific you would like to ask me?

MR. RUBLOFF: Well, I know in other cases it has been the Court's practice to respond to —

THE COURT: To the written questions?

MR. RUBLOFF: To the questions that were specified by the parties as representing the issues in fact.

THE COURT: I looked at this case, and it got so involved and so far from what it was that I actually saw was relevant to the case that I decided not to go down the list of everything. I just didn't think they were all that important. But if you have something that you would like to call my attention to that you think is really important that I have not resolved, by all means call it to my attention.

I may get a copy of the order and go down with all of you when this is done. I was going to do it, and after four weeks of trial things got so, in my mind, so far afield from some of the thing that were in that order specified as issues in dispute that I decided not to do anything with it.

Let me go through and deal with each case, and then we can go back and answer specific questions. Was there anything in particular that you had in mind?

MR. RUBLOFF: No, Your Honor, I didn't mean to make any proposal or request, it was simply an inquiry because I was [3584] aware of the fact that in prior cases it had been your practice to respond specifically to the matters contained in, I think it is what you call the order governing —

THE COURT: Proceedings at trial.

MR. RUBLOFF: Right. I just wanted to clarify what the Court's —

THE COURT: Sometimes I do and sometimes I don't, depending on whether I think it is important, depending on whether the parties think it is important. I look at it, and I did look at it before the last time I met with you to see whether following down that pathway would prove fruitful, and given the fact that the case was tried by one side geared to DAV to some extent, and somewhat differently by the other side, and since I decided DAV was not really relevant and controlling in this case, because in DAV there was a commercial transaction, you know, the buyers were not related parties, and here there was a difference in that element.

I may go back, let me get a copy of the order and then I may go back and answer some of your questions. Of course there will always be time in remand to answer some of those questions, too, and there will be remand.

In any case, the question of the four individual Plaintiffs, in a way I found was the most troubling aspect of the case, some of them because the way the case was tried by both sides much of the focus was directed on the Endowment case [3585] itself. To some extent there is value in that, because if I understand things correctly, had the Endowment lost that would pretty much have taken care of the individual Plaintiffs. Given that the Endowment has won makes it, I think, a much more difficult case to deal with individual plaintiffs.

And I, you know, had some misgivings, some of which I expressed the last time, about the perception that was conveyed, at least by some of the witnesses, that somehow there was one unitary market for insurance. In fact, it is quite clear there were many markets for insurance, geographically and otherwise. Certainly geographically there were large differences, and I was troubled by the possibility that some — and I still am — that some members of the American Bar Endowment who buy insurance may



be getting a terribly good deal, and may get a charitable deduction, when in fact, this is the best deal they could get.

And I was equally troubled that a blanket rule going the other way would perhaps deprive some people who are in fact making a contribution from deduction. But then I thought about it some more and decided it is really my province to decide cases and I will leave policy to people who are paid to set policy, and I can only decide the cases that are before me, and let future cases, future lawyers, future judges, those involved in the administration of justice and the administration of income tax laws and federal regulations deal with questions of [3586] equity and equality and what not.

So I went to each individual plaintiff, and I looked to see what there was in the file or what was in the record that would support his claim for a charitable contribution. And in trying to analyze the evidence I considered the dual payment cases, the cases that talk about making a charitable contribution while paying for something else, and I also considered the authority cited by the United States Government, and the conclusion I came to was that there must be some showing that the payment made had at least in part a charitable component.

That there must be showing that he was not entirely motivated by some other collateral economic concern. If the record did not establish that, the existence of some charitable component, I decided that that plaintiff should not prevail.

In the case of insurance the question was did somebody buy more expensive insurance than he or she, I guess he in this case, could have gotten by — did he buy American Bar Endowment insurance, which was a much worse deal or significantly worse deal than what would have been available elsewhere in the market. And I took each of the plaintiffs in order and looked at the status and what else

was in the record, and in the case of Mr. Broadfoot I decided that he did not make such a showing, and I am holding, in his case, in favor of the Defendant.

[3587] Mr. Broadfoot, if I did not get my names confused, I believe was one of the gentlemen who lived in Georgia. He had ABE life insurance in the amount of \$50,000, and he said that he was aware at the time he made the application, or the time he paid the check, he was aware of the fact that a portion of this payment would be used, albeit collaterally when it comes back as a dividend, but would be used to support a tax exempt charitable type of activity.

But that is not enough, at least in my reading of the law. Simply knowing that part of a payment goes to a charitable endeavor does not, in my view, render this payment charitable if in fact the payment was entirely motivated, could have entirely been motivated by other economic concerns.

So it is perfectly consistent for somebody in Mr. Broadfoot's position to have no sympathy at all for the American Bar Endowment, although I am certain that he, in fact, did, or else he wouldn't have been here — it would have been perfectly consistent to know that a portion of the payment were going to those types of activities, and yet paid grudgingly. Pay it, but not be particularly happy about it, or not have that motivation at all, and we had at least one witness who said as much.

He said he was not upset about the fact that the things were going to the ABE, but that was not a motivating factor at all. I found nothing in Mr. Broadfoot's testimony to [3588] suggest that the charitable contribution was, in fact, motivating him to buy the insurance from the ABE. It is curious with all these plaintiffs what they did not say, given that they were on the stand and able to testify.

They did not say that they selected this insurance over cheaper available coverage that they had, or equal coverage. Certainly, Mr. Broadfoot did not. He made no

indication that he didn't—and not only that, it is enough that he didn't look for the insurance, perhaps because he was so enamored with the idea of contributing to the ABE. Really, nothing at all that would support the view that he, in fact, bought the ABE insurance at some economic cost to him, at some additional economic cost to him, in order to support American Bar Endowment.

If one looks at the Georgia life plan, and I have said already on this record I find that, Georgia Bar Association plan, and I already said on this record that I find the individual insurance to be materially different from association type of insurance, and I continue to adhere to that view. I believe that individual insurance, because of the differences in portability, the differences in the ability to get it with or without medical examination, is a different product.

In group insurance, where everybody in the group can get it, it may be limited to in some way geographically, it may be tied to payment of some collateral membership fee, like one [3589] has to be a member of the ABA in order to be able to buy the ABE insurance, I find them to be significantly different commodities. So I look at what might have been available to Mr. Broadfoot in Georgia, and the inference is that—well, certainly there was no evidence that he, in fact, considered any other plan, but in fact, the rates were not considerably different between the Georgia plan and the ABE plan, if I remember the figures correctly.

The question of Mr. Broadfoot, as to whether he considered the ABE plan to be outrageously overpriced at the time he bought it, he said he did not, and really, there was no indication at all, certainly not enough of an indication to persuade me that he, in fact, rejected the cheaper available coverage because he felt he wanted to buy the more expensive coverage in order to contribute to the ABE.

So in the case of Mr. Broadfoot I decide in favor—in fact, now that I look I see that Mr. Broadfoot noted that the cost of the Georgia program, in fact, exceeded the cost of the ABE, the Georgia Bar plan exceeded the cost of the ABE coverage. In light of all of that, I simply cannot find that he was making a charitable contribution.

Mr. Turner. Well, let's take Mr. Boynton, who was the other gentlemen who was in New York—I'm sorry, in Georgia. Mr. Boynton had a separate issue involving the Ionosphere Club. That issue was resolved in his favor when the Government [3590] proceeded and had put no evidence contrary to his testimony in any case, so on that issue Mr. Boynton wins. Mr. Boynton, if my notes are correct here, was involved in the disability [*sic*] program rather than the life program of the ABE. Again, he noted that he was aware that part of his payment of the premium reflected a payment towards the American Bar Endowment's charitable activities.

There was, however, no indication as to what other coverage might have been available to him. He did say he did look at other available plans. He did not say that those were significantly less expensive, and then he bought American Bar Endowment plan at some additional economic sacrifice to him in order to make a charitable contribution.

As far as this record reflects Mr. Boynton, too, seems to have gotten—at least there is nothing in the record that suggests other than that Mr. Boynton took the best deal he could get on the market. In that case, I found the motivation for purchasing insurance was entirely economic, and that his entire motivation is covered by economic interest, and cannot be deemed, any portion of it can be deemed to be charitable.

Mr. Turner. He is from New York. The interesting point in his testimony is that he says he is not a member of the New York State Bar Association. I must have been



under a misapprehension of fact at some point in the proceedings, because [3591] I did not recall this, and I had thought that New York like some other states must have an integrated bar, and that being an attorney in New York State would make one automatically a member of the New York State Bar Association. Of course, that is not true in all states, and apparently Mr. Turner's testimony is that that is not true in the State of New York.

I surmise from this that the New York State Bar Association is a voluntary association. It is a voluntary association of which Mr. Turner is not a member, or was not a member at the time he testified, and I don't think he was a member—I can't tell from his testimony, he says he was formerly a member, it is not clear when, but I gathered from what was said that he was not a member in the tax years in question.

I find Mr. Turner's case just a little bit more difficult because apparently he had had some other insurance, and it is not entirely clear why he switched. It certainly would be consistent to say he might have switched to the ABE plan because he wanted to make a charitable contribution, and he might have switched from a less expensive to a more expensive plan, but he doesn't say that.

He said that he had policies with Provident Mutual and Drexel Life Insurance, it would have been easy for him to say that those plans or establishing those plans were cheaper, and he was doing what would be counter-intuitive moving to a more expensive plan from a cheaper one, or give some other [3591-A] indication that, in fact, he chose ABE other than for the fact it was the best deal in the market. The burden is on the plaintiff. It was not established in the case of Mr. Turner.

I note that he was not a member of the New York State Bar Association, so he could not have taken advantage of the favorable rates available under that plan from New York Life Insurance Company. Those rates, from what

the evidence shows, were more favorable, at least for some age brackets. It is not clear to me why Mr. Turner was not a member, what the cost of membership would have been, what other implication there would have been for this membership, so it is certainly impossible to tell whether—on this fact, as to whether whatever cost would have been associated with becoming a member or obtaining membership in the New York State Bar Association, when added to the premium he would have paid for the insurance would, in fact, have made the New York State Bar insurance, where would that be in relation to the ABE.

There is no other evidence on the record that I could see relevant which would suggest other than an entirely economic motive on Mr. Turner's part. Again, the fact that he knew that part of his premium was going to these charitable endeavors of the ABE is not sufficient, at least in my view of the law.

The most interesting and difficult case involved Mr. Sherwood, and again I just decided these one case at a time, and [3592] I suppose with 50,000 or 75,000 members of the ABE might come trotting in here, I don't know what to say. These are the cases I have before me.

I note, first of all, that he had both life and dependent insurance. As to the dependent insurance, I—again, this is a voluminous record and I did not go hunting through it at great length, but as far as I can tell there was really nothing in the record to show comparison of rates available for the dependent insurance. There was no indication affirmatively from Mr. Sherwood that he bought dependent insurance at great economic, or a greater economic sacrifice to himself in order to benefit the ABE.

So as far as the dependent insurance is concerned, I find in favor of Defendant and against the taxpayer.

Now, on the life insurance, what makes this case interesting is that Mr. Sherwood was a member of the New York Bar Association. According to his application for



ABE insurance Mr. Sherwood was born in 1939. This is Exhibit No. 353 in the record, and I have no reason to doubt its accuracy. So that means that in 1979 he reached his 40th birthday, in 1980 he would have reached his 41st birthday—in 1980 he would have been 41, in 1981 he would have been 42.

So we have here an individual who was, in fact, eligible for the New York Bar plan, and for whom in the age bracket of 40 to 44, which he would have been in at least for the most [3593] part of those three years, the New York plan would have been somewhat cheaper for the first year, and significantly cheaper for the second or additional years. Apparently the New York plan, there was a high premium in the first year.

So that posed an interesting question, whether the availability of this plan alone, the availability of what I consider to be an equivalent product in the market, in that particular market, would have been a sufficient indication that another product was considered, was rejected, and therefore, the inference ought to be drawn that the taxpayer was choosing a more expensive and less advantageous economic product, and therefore, was doing so for charitable purposes.

That case gave me trouble. It also gave me trouble on—Mr. Sherwood's case also gave me trouble on another count. He had \$320,000 worth of insurance, with \$20,000 of that apparently being with the American Bar Association, and \$320,000 is a fairly odd amount, so there is somewhat of an inference that he bought \$300,000 insurance somewhere, and then maybe \$20,000 from the ABA or the ABE.

Unfortunately, he really didn't say anything of that sort. I looked, and tried to find some indication as to what was going on in his mind when he bought or obtained the insurance. Apparently he bought the insurance in the early '70s and then raised the coverage from \$8,000 to \$20,000

in 1978. He does state that he was aware that a portion of the payment that [3594] he made to the Endowment was for, or would go for charitable purposes. But nowhere does he really say that he could have gotten the extra \$20,000 of insurance more cheaply from his insurance company, or indeed, from the New York Bar Association, and that he rejected those in order to make a contribution.

In fact, apparently he was a member of the New York Bar life insurance program, and rejected that, let the coverage lapse later. It is not explained as to why he did that.

It is a close case in my mind. In order to have Plaintiff prevail, at least in my mind, it would have to be established that, in fact, an equivalent product was available in the market at a significantly lower cost, and I think in this case that was established.

I think it must also be established that the product was known to the taxpayer, and that an affirmative decision was made to reject the lower priced product, and that affirmative decision was based on some desire to make a charitable contribution, and although I find this case close, I decided against the taxpayer and in favor of the Defendant.

There are things that Mr. Sherwood could have said that he did not about his decision to reject or discontinue his coverage under the New York State Bar plan, there were things he could have said as to what the expense would have been of buying an additional \$20,000 of insurance privately, if indeed, that was available, which I assume that it was.

[3595] Finally, although I don't think there is anything wrong with this, I think some weight has to be given to the fact that American Bar Endowment insurance was marketed aggressively, and with many indications in the literature that this was a good deal, and a good buy, and I don't mean to suggest that there is anything at all wrong with that.

Given what I have said, the nature of Endowment's endeavor was, and that was that it was a contribution, it was not a business. It was a way for the members to make this economic good available as a group for conducting charitable purposes. I think it was incumbent upon those running the Endowment to try to run it in a way which would maximize, I guess one would call the revenues, or maximize the benefit to the Endowment from this nice advantage that was provided by the members.

So I think there is nothing wrong at all with advertising that is aggressive, and in some ways suggested this may be the best deal in the market, and indeed, for many people, from the best I can tell, across the country it may very well have been a very good deal, indeed, and perhaps the best deal. It may, in fact, not have been, and I'm not sure that they ever claimed for it to be the best deal in all circumstances, but I think there was enough in the literature where if Mr. Sherwood did not have the two plans side by side, and could not see the exact rates for his particular age group, he might not be aware [3596] of the fact that he could have gotten an extra \$20,000 of insurance from the New York Bar Association for perhaps less than he could have with the ABE.

I think it is a leap of faith which is one I'm not going to take without benefit of testimony from the Plaintiff. If Plaintiff wishes to tell me that he has considered a lower cost alternative, rejected it because he wanted to make a contribution, that may very well be a different case. In fact, in my view of the law I would, again depending on the facts of the case, probably rule in favor of the Plaintiff if such a showing were made. But a showing must be made by the Plaintiff, and I found in the case of all four Plaintiffs that the showing was simply not made.

Now, I understand why the showing might not have been made. These are test cases, and I suppose a broader victory is always better than a narrow one, a victory

where—I am just surmising, just assuming this is what might have happened—that if less is served that is fact specific, and these plaintiffs survive that would, of course, be of much greater precedential value one way or the other, in resolving what is a knotty, knotty legal issue and will affect the conduct of the Endowment and the collection of revenue laws for many years in respect to many people.

I wish I could have come up with a more creative and less fact specific decision in these cases, but from my reading [3597] of the law I simply can't. I will not exclude the possibility that under the right set of fact [*sic*] the Plaintiff could show that the purchase of insurance had a charitable component, and in fact, was motivated by more than economic desire to buy insurance. I think the authorities compel that. But on the other hand, I cannot say that once it is established some of those dollars go to charity under any and all circumstances, a portion of the payment was charitable, without assistance from above—just one or two floors above—I don't think I can take either of those positions.

Now, Appellate Courts and Members of Congress and those in the Internal Revenue Service have to look at the broader picture, or may have to look at the broader picture. My responsibility is to decide the cases I have here, and that is where I come down.

So after a truly careful review of the situation of the four plaintiffs, and I have given it considerable thought, I find that the required showing was not made for any of them, except for the one Ionosphere matter which we can put aside, and that I will rule in favor of the Defendant.

Now, do I have my order governing proceedings at trial? Do you have a copy? Is there something in particular you want to ask me? I have copies here you can look at. Someone made some notes, and you know, I don't remember why. I don't think it was me, probably



somebody else. I mean, there are little [3598] yeses and nos and whatever, it might have been a law clerk. I'm willing to let you look, and don't take whatever is there in terms of notes as a — I don't know what the notes are, so just ignore them.

As you go through, I will answer any questions that you think are not clear by now, or that — just take your time and go through it, and I will be happy to answer them. I will also use this in writing an opinion, to make sure I cover whatever points I cover or need to be covered.

If you want, I can go through and answer what I can answer. I mean, some of them seem fairly easy, some of them seem complicated and pointless. I don't mind going through and trying to answer.

Maybe we should just go down the list one time and see what we have.

On page 3, Paragraph V, Issues in Dispute.

"The parties agree that the ultimate questions of fact and law in this case are:

a. As to the individual plaintiffs, did they make charitable contributions to the Endowment during the taxable years by virtue of the Endowment's receipt of dividends and experience credits and, if so, in what amount?"

I think I answered that question. It is, as to each individual plaintiff, that they did not.

"b. As to the Endowment, did it have unrelated [3599] business taxable income arising from its receipt of dividends and experience credits during the taxable years and, if so, how much?"

I have answered that question as no, it did not have unrelated business income.

Now we get to the difficult questions, okay?

"Subsidiary Questions, A. 1. Did the individual plaintiffs, in making their premium contributions to the Endowment, make "dual payments" part as a contribution of

dividends and experience credits to the Endowment for charitable uses in the field of law, and part for insurance coverage?"

That is a very difficult question to answer. It is quite clear that the payments that they actually made were, in fact, partially used to buy insurance, and partially by way of the dividends then used to support the charitable purposes of the Endowment. I'm not sure whether anything more is implied in the question in the concept of dual payments.

Does either side wish to speak to that?

I have said that that does not necessarily apply to a charitable contribution. I do recognize that part of each, and I do find that part of each check paid, at least with these individual plaintiffs, that each check contained — well, that each check was used in part to pay for insurance, and in part eventually through dividends to pay for the Endowment's charitable purposes. Is that satisfactory or clear?

[3600] MR. THROWER: May I make a brief comment on that Your Honor?

THE COURT: Of course, Mr. Thrower.

MR. THROWER: But I haven't seen in your comments or heard in your comments a reflection or comment on our position that the group, by a group decision, has been making a group gift, that it could by a group decision change that in any year, and that where the group participates in the group decision in making a contribution equal to the difference between what they pay and what they could have paid had they made the decision to get the full economic benefit for themselves, that that constitutes the measure of the group gift, and the allocation of it made on an objective basis, and rather than on a subjective basis, would follow what we have done, what the Endowment has done, and what is customarily done under Section 61 and under Section 79.



THE COURT: Well, I accept that theory, and to my mind it brings one so far as to say this is not a business, and therefore, Endowment is not subject to a regular business income tax.

The problem is that by that argument every member of the Endowment makes a contribution, whether they buy insurance or they don't buy insurance. That those who do not buy insurance from the Endowment are nevertheless making the contribution, and that is the economic opportunity of buying—that they forgo [3601] in having the much cheaper insurance available to them, causing them perhaps to go out and buy—

MR. THROWER: That is certainly true. They make a sacrifice, each member of the American Bar Association, and thereby a member of the Endowment. Each member who does not have the insurance makes the sacrifice. Only the insured members actually pay money which constitutes what we assert is a charitable deduction.

So the sacrifice of the others is essential in order to permit the ongoing program, but it is only the insured members who paid the money, and that entire group of people, whether they are high risk—they might be quite high risk, they might be quite low risk—nevertheless, as a group have the opportunity of getting the insurance at the low cost without any charitable element written into it.

This was the concept that we undertook to reflect, rather than the subjective approach of looking at each member, which I don't think was really advocated by either party, and as we indicate I believe in the earlier filings, it has generally been disapproved both by the Courts and by rulings of the Internal Revenue Service in favor of the objective approach, as is followed under Section 61 and 79, where—

THE COURT: Well, Section 79 is a specific statutory provision, which is a problem—

MR. THROWER: It is specific, simply reflecting this [3602] general principle, however.

THE COURT:—that Congress has addressed.

MR. THROWER: That's right.

THE COURT: I am just not able, Mr. Thrower, to—perhaps a case by case approach is not appropriate, and in that case, I simply would rule for the Defendant. I view the question of whether something is a business as something that can be made as a group decision. I don't view the question of whether one makes a charitable contribution as a group decision. That is an individual decision, and the majority of the members of the Endowment cannot make that for the minority.

They can certainly keep them from getting an economic benefit by making a group decision as to what the rates are going to be, but the idea of being forced to make a gift goes contrary to my conception of what a charitable contribution is. I remember Mr. — I don't know why I always forget his name, he was the gentlemen with the cane—

MR. WATKINS: Mr. Burnett, Your Honor.

THE COURT: Mr. Burnett, and he paid more for the insurance than he would have paid, but apparently he got the best deal he could, and the fact that he was a member of the group, the majority of which chose to make a charitable contribution, I just don't think that that made him a charitable contributor. He was buying insurance, the best deal he could get, and without—

[3603] MR. THROWER: As to Burnett, our position would be that as a member of the group the Burnetts are entitled to participate in this group gift in the same way as others. If they did not participate, then the participation of those with an average risk or better than average risk, their participation in the gift would be larger, because the group gift remains the same, but because the group itself could in any year by a group decision reduce the net cost for every member of the group, including the Burnetts, it seemed to us that each member should participate.

Otherwise, if you went to a subjective position on that basis, those in good health and better risk would have a great part of this group gift when you eliminated the Burnetts in the high risk.

THE COURT: Mr. Thrower, I understand your argument, I really do. I simply don't find the model classification. It may be up to the Court of Appeals to come up with —

MR. THROWER: Well, we do appreciate your attention to it.

THE COURT: I understand well enough, and I do find it persuasive in the context of whether this is a business or not. I think that one can as a group make a decision not to operate something as a business, to allow high premiums to be charged voluntarily, and that that does not then render what the revenues, the net revenues as being profit. That far I am [3604] willing to go. This concept of a group gift, I just don't think we have a model for it, Mr. Thrower. I think this would be the first case. We would have to resort to something like the Section 79 tables, which is something Congress specifically thought about and legislated, and I like to think of myself as fairly daring and imaginative, but my daring and my imagination has boundaries.

I'm willing to make all of the findings you wish to set up the issues for appeal. I think these are important issues, and obviously they are going to be decided on appeal, and you have my sympathy. I simply have to follow the law as I see it, and with appropriate limitation of my discretion given that I'm a trial judge and not an appeal judge.

For what it is worth, I recognize that all of the facts you have stated, or all of the things you have presented are, in fact, true. The Endowment could have set the rates lower, it set rates higher — and in fact it is required from an earlier decision — it sets rates higher by a democratic majority

process which could have been changed by — I specifically find could have been changed from year to year if there were an impetus for it.

I found that there is no reason to believe that the American Bar Association processes are such that they would not be susceptible to democratic change. On the contrary, I would expect they would be, and that, in fact, by consent of the [3605] majority, and probably overwhelming majority of the members, this enterprise has been run in a non-business fashion in a way which would be to the general detriment of the group as a whole for the benefit of the association.

Equating that into a group gift for purposes of getting a charitable deduction, I just cannot take it that far.

MR. THROWER: That is where we part, yes. But we understand your position. Thank you, Your Honor, we do appreciate your attention to the case, we know you have given it a lot of thought.

THE COURT: I was going down the list. If there is anything else that needs to be addressed — let's see, item A. 2. on page 4:

"Is the quid pro quo or private financial benefit received by the insured members from their participation payments properly measured by the net cost of the insurance (gross premiums less dividends or experience credits) plus related expenses or is it measured by the gross premium paid to the insurance companies?"

I never understood that question. Does anybody want me to answer that question? I will try to bisect it for you — I mean, is anybody — Mr. Rubloff?

MR. RUBLOFF: Your Honor, I have the uncomfortable feeling that perhaps I have prodded the Court into responding specifically at this point in time to these questions, when I [3606] really didn't intend —



THE COURT: I'm not going to go down and make specific findings of fact, I'll write an opinion, so if there are specific points you want me to hit, you want to be sure that I hit, I think this is the time to ask me. Now, I might cover them in any case, but I might not.

MR. RUBLOFF: Well, Your Honor, my question is that the Court has in the course of its comments on the resolution of the various cases effectively resolved all of the disputed issues of fact, and I find it somewhat troublesome to impose upon the Court now the burden of having to respond to two separate sets of questions posed by the parties, each of which would understandably be posed in such terms as to perhaps favor their respective positions, or to generate an answer to their liking.

So for the Government's part, I am perfectly content if the Court would prefer to defer making any findings at this time and would simply incorporate its findings in its opinion, with the wareness [sic] that the parties are interested in the resolution of the subject matter raised by each parties' questions.

THE COURT: That's fine with me. I mean, I don't understand all of the questions, and maybe if I get back into it I would just as soon not go through it. So I take it you are equally unhappy with the case by case approach as Mr. [3607] Thrower is?

MR. RUBLOFF: Yes, Your Honor. I feel that you have correctly stated the law with respect to the resolution of the individual plaintiffs' cases.

THE COURT: No, my question was, I assume you are equally unhappy about the case by case approach? Mr. Thrower seems to think that that would be unworkable. I think it is unworkable.

MR. RUBLOFF: Well, I don't know if it is appropriate for me to express my personal opinion. I think you have properly stated the law with respect to the individual cases, and I think you have properly applied the law to the facts of those particular cases.

THE COURT: But you understand, Mr. Rubloff, when I come out with the writing I will allow for the possibility that 75,000 members can come in here and make a case that they made a contribution, and if they make that showing, if I'm correct in my ruling, they will win.

MR. RUBLOFF: I understand that, Your Honor.

THE COURT: I don't know how happy you are with that.

MR. RUBLOFF: Well, I don't think I'm unhappy, this is really irrelevant.

THE COURT: It doesn't thrill me.

MR. RUBLOFF: I don't think that my happiness is really relevant. I think my function is to ensure that the law [3608] is properly applied, and I do believe that is the case here, and we will just have to take each case as it arises.

THE COURT: Well, I have had three trials since this case finished. I have a two-week trial in January, so don't look for anything before February. I have things to do and places to go, and I do think the case is important and needs to be resolved, and I will write something because obviously many of the issues, at least some of the issues are—and I will try to do as fair and as clear a statement of what I'm deciding as possible so as to give the Appellate Court an opportunity to reverse it or whatever. I'm not pulling any rabbits out of the hat, I'm trying to be mindful of the position of both parties, and include in my statement of facts as much as I think the parties would want and need in order to make their case on appeal. No doubt the case is going to go on appeal.

I should say though that what I have said here on the record, and what I said the last time on the record, are my findings, and if anything is not included in the opinion it should be—if anything I have stated on the record is not included in the opinion, that should be viewed as a finding of fact, and can be used for purposes of appeal.



Let me now for the last time, and this is, I think, the last time we're going to probably meet before I issue an opinion, let me encourage the possibility of settlement. I [3609] know people have tried, you know a little bit more now. I have no idea what went on before. You have a little bit more, pieces of information, and since nothing is going to be forthcoming from me, at least until February, I just cannot do it, it is simply not possible, go back and reflect, factor in additional information and don't be bashful.

There is plenty of room for me to be wrong on both issues. I think this is a difficult case, I think this is an unusual case, and I think it is a case where the outcome on appeal is highly in doubt. So now you know a little bit more.

You know, I am only sorry I was not able to come up with something in the case of the individual plaintiffs that I could live with and that would take care of things in a more blanket fashion. I am not terribly happy about this way of resolving the case, but I guess I did the best I can, and let people with greater authority to do more.

I would suggest, on the basis of what my comments have been, and on the greatest likelihood that I will not change my mind, and I think it is very clear I will not change my mind, I would like you all to work out a stipulation with the amount of judgment in the Endowment case, because my opinion will require you to file one, because I assume nobody is going to want me to go through the ledgers and figure out the dollars and cents. Yes?

MR. GREGORY: It has been stipulated, Your Honor.

\* \* \* \* \*

CC: I-4119  
Br5:DMRoth

G.C.M. 36713

April 20, 1976

---

JOHN L. WITHERS

Assistant Commissioner (Technical)

Attention: *Director, Individual Tax Division*

In a memorandum dated January 13, 1976, the Individual Tax Division (T:I:I:1:3) requested that this Office reconsider the position expressed in several G.C.M.'s that the "detached and disinterested generosity" concept enunciated by the Supreme Court in *Commissioner v. Duberstein*, 363 U.S. 278 (1960), should not be applied with respect to the deduction of charitable contributions under *Int. Rev. Code of 1954*, § 170 [hereinafter cited as *Code*]. See, e.g., G.C.M. 36360, \_\_\_\_\_ I-72-74 (Aug. 6, 1975); G.C.M. 35251, \_\_\_\_\_, I-5114 (Feb. 26, 1973); G.C.M. 34956, \_\_\_\_\_, I-4771 (July 20, 1972), *considering before publication* Rev. Rul. 72-506, 1972-2 C.B. 106; G.C.M. 34863, \_\_\_\_\_, I-4119 (April 28, 1972). The Individual Tax Division indicated concern that the Government was continuing to rely on the *Duberstein* "detached and disinterested generosity" concept in cases involving *Code* § 170 even though this Office has taken the position that such reliance is not appropriate.

This document is not to be relied upon or otherwise cited as precedent by taxpayers.

Although there have been instances in which Government attorneys have cited *Duberstein* in Code § 170 cases, we do not believe that there is any disagreement within this Office with respect to the position set forth in the G.C.M.'s cited above. We have coordinated this matter with our Refund Litigation and Tax Court Litigation Divisions and have been advised that both divisions are in agreement with that position and are not recommending or approving use of the *Duberstein* concept in Code § 170 cases. We agree with the Individual Tax Division that it is important to maintain a consistent position in Code § 170 cases in litigation and hope that inadvertent reliance on *Duberstein* can be avoided in the future. It appears, however, that because there is no disagreement with the position taken in the G.C.M.'s cited above, reconsideration of those memoranda is not warranted at this time.

MEADE WHITAKER  
Chief Counsel

By: /s/ JAMES F. MALLOY  
JAMES F. MALLOY  
Technical Assistant to the  
Division Director  
Interpretative Division

## Supreme Court of the United States

---

No. 85-599

---

UNITED STATES, PETITIONER

v.

AMERICAN BAR ENDOWMENT, ET AL.

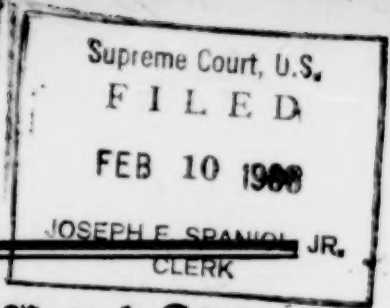
---

ORDER ALLOWING CERTIORARI. Filed December 2, 1985.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Federal Circuit is granted.

Justice Powell and Justice O'Connor took no part in the consideration or decision of this petition.

(6)  
No. 85-599



---

**In the Supreme Court of the United States**

OCTOBER TERM, 1985

---

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT, ET AL.

---

ON WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE FEDERAL CIRCUIT

---

**BRIEF FOR THE UNITED STATES**

---

**CHARLES FRIED**

*Solicitor General*

**ROGER M. OLSEN**

*Acting Assistant Attorney General*

**ALBERT G. LAUBER, JR.**

*Assistant to the Solicitor General*

**GARY R. ALLEN**

**ROBERT S. POMERANCE**

*Attorneys*

*Department of Justice*

*Washington, D.C. 20530*

*(202) 633-2217*

---

---

54100



## **QUESTIONS PRESENTED**

1. Whether income derived by a charitable organization from the sale of group insurance to its members is "unrelated business income" subject to tax under Sections 511 through 513 of the Internal Revenue Code.

2. Whether an insured member of such an organization is entitled to deduct a portion of the premium that he pays for such insurance as a "charitable contribution" under Section 170 of the Code.

## II

### PARTIES TO THE PROCEEDING

In addition to the parties named in the caption, Frederick D. Turner (and his wife), Arthur M. Sherwood (and his wife), Herbert C. Broadfoot II (and his wife), and Frederick G. Boynton are respondents.

## TABLE OF CONTENTS

	Page
Opinions below .....	1
Jurisdiction .....	1
Statutes involved .....	1
Statement .....	2
A. The facts of these cases .....	2
B. The proceedings below .....	8
Summary of argument .....	14
Argument:	
I. Income derived by a charitable organization from marketing and administering a group insurance program for its members is subject to tax as unrelated business income .....	16
A. The term "trade or business" includes any activity regularly carried on with the intention of making a profit from the sale of goods or the performance of services, and Congress intended that this definition would embrace insurance activities of the type carried on by respondent .....	16
B. Because respondent engaged in a regular and extensive course of commercial activities with the intent to make a profit, its insurance operations are a "trade or business" and its insurance income is subject to tax....	23
C. The justifications advanced by the courts below do not support their decision to exempt respondent's insurance profits from unrelated business income tax .....	31
II. Respondents are not entitled to deduct any portion of their insurance premiums as a charitable contribution because they failed to prove that the price they paid for the insurance exceeded its fair market value .....	40

## Argument—Continued:

## Page

A. A transfer to a charity is not a "contribution" or "gift" if the transferor receives, or expects to receive, commensurate economic benefits in return .....	40
B. Respondents are not entitled to a charitable contribution deduction because they failed to prove that they paid more for the insurance than it was worth .....	43
Conclusion .....	47

## TABLE OF AUTHORITIES

## Cases:

<i>Arceneaux v. Commissioner</i> , 36 T.C.M. (CCH) 1461 .....	42, 43
<i>Besseney v. Commissioner</i> , 379 F.2d 252 .....	18
<i>C.F. Mueller Co. v. Commissioner</i> , 190 F.2d 120....	16, 32
<i>Carolinas Farm &amp; Power Equipment Dealers v. United States</i> , 699 F.2d 167 .....	25, 26, 27-28, 36
<i>Disabled American Veterans v. United States</i> , 650 F.2d 1178 .....	36
<i>Goldman v. Commissioner</i> , 388 F.2d 476 .....	41, 42, 47
<i>Helvering v. Taylor</i> , 293 U.S. 507 .....	45
<i>Hirsch v. Commissioner</i> , 315 F.2d 731 .....	18
<i>Iowa State University v. United States</i> , 500 F.2d 508 .....	18
<i>Lamont v. Commissioner</i> , 339 F.2d 377 .....	18
<i>Louisiana Credit Union League v. United States</i> , 693 F.2d 525 .....	25, 26-27, 30, 31, 35
<i>McDowell v. Ribicoff</i> , 292 F.2d 174 .....	17-18
<i>Murphy v. Commissioner</i> , 54 T.C. 249 .....	42, 43
<i>Professional Insurance Agents v. Commissioner</i> , 78 T.C. 246, aff'd, 726 F.2d 1097.....	25, 26, 28, 31, 35
<i>Roche's Beach, Inc. v. Commissioner</i> , 96 F.2d 776..	16
<i>Rockwell v. Commissioner</i> , 512 F.2d 882 .....	45
<i>Sedam v. United States</i> , 518 F.2d 242 .....	41, 45
<i>Seed v. Commissioner</i> , 57 T.C. 265 .....	42
<i>Singer Co. v. United States</i> , 449 F.2d 413 .....	42
<i>Stubbs v. United States</i> , 428 F.2d 885 .....	41-42
<i>Welch v. Helvering</i> , 290 U.S. 111 .....	45

## Statutes and regulations:

## Page

Act of Aug. 29, 1972, Pub. L. No. 92-418, 86 Stat. 656 <i>et seq.</i> .....	22
§ 1(a), 86 Stat. 656 .....	22
§ 1(b), 86 Stat. 656 .....	22
§ 1(c), 86 Stat. 656 .....	22
Internal Revenue Code of 1954 (26 U.S.C.) :	
§ 162(a) .....	17
§ 170 .....	1, 40, 41
§ 170(a) .....	9
§ 170(c) (2) .....	40
§ 170(c) (2) (B) .....	9
§ 501 .....	1
§ 501(c) .....	20, 21
§ 501(c) (3) .....	2, 9, 29
§ 501(c) (4) .....	21
§ 501(c) (6) .....	2, 29, 30, 31
§ 501(c) (7) .....	21
§ 501(c) (8) (1964 ed.) .....	19
§ 501(c) (8) .....	39
§ 501(c) (9) .....	19
§ 501(c) (19) .....	22, 39
§ 502(a) .....	17
§ 511 .....	1, 17
§ 511(a) .....	19
§ 512 .....	1, 17
§ 512(a) .....	9, 11
§ 512(a) (1) .....	8, 17
§ 512(a) (4) .....	22
§ 512(b) (10) (1976 ed.) .....	9
§ 513 .....	1, 17
§ 513(a) .....	8, 9
§ 513(c) .....	<i>passim</i>
§ 514 .....	17
§ 515 .....	17
Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 <i>et seq.</i> .....	18
§ 121(a) (1), 83 Stat. 536 .....	19
§ 121(c), 83 Stat. 542 .....	19



## Statutes and regulations—Continued:

Page

## Treas. Regs.:

§ 1.501(c)(6)-1 .....	1
§ 1.513-1 .....	1, 18
§ 1.513-1(b) .....	18, 36, 39, 40
§ 1.170A-1(c)(2) .....	42-43

## Miscellaneous:

B. Bittker, *Federal Taxation of Income, Estates and Gifts* (1981):

Vol. 2 .....	41, 42
Vol. 4 .....	31
32 Fed. Reg. 17657 (1967) .....	18
H.R. Rep. 2319, 81st Cong., 2d Sess. (1950) .....	15, 17, 33
H.R. Rep. 1337, 83d Cong., 2d Sess. (1954) .....	41, 45
H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1 (1969) .....	18, 19, 20
Rev. Rul. 67-246, 1967-2 C.B. 104 .....	42, 43
Rev. Rul. 68-432, 1968-2 C.B. 104 .....	42
Rev. Rul. 80-233, 1980-2 C.B. 69 .....	43
S. Rep. 2375, 81st Cong., 2d Sess. (1950) .....	17
S. Rep. 1622, 83d Cong., 2d Sess. (1954) .....	41
S. Rep. 91-552, 91st Cong., 1st Sess. (1969) .....	18, 20
S. Rep. 92-1082, 92d Cong., 2d Sess. (1972) .....	21, 22
Schwarz & Hutton, <i>Recent Developments in Tax-Exempt Organizations</i> , 18 U.S.F.L. Rev. 649 (1984) .....	33

## In the Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-599

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE FEDERAL CIRCUIT

## BRIEF FOR THE UNITED STATES

## OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 761 F.2d 1573. The opinion of the Claims Court (Pet. App. 25a-58a) is reported at 4 Cl. Ct. 404. The oral findings of the Claims Court (Br. in Opp. App. A1-A22, B1-B24) are unreported.

## JURISDICTION

The judgment of the court of appeals (Pet. App. 24a) was entered on May 10, 1985. On July 31, 1985, the Chief Justice extended the time within which to petition for a writ of certiorari to and including October 7, 1985. The petition was filed on that date and was granted on December 2, 1985. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

## STATUTES INVOLVED

The relevant portions of Sections 501, 511, 512, and 513 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Sections 1.501(c)(6)-1 and 1.513-1 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out at Pet. App. 59a-76a. The relevant portions of Section

170 of the Internal Revenue Code are set out at Br. in Opp. App. C1.

## STATEMENT

### A. The Facts of These Cases

1. The American Bar Endowment, the corporate respondent, is an organization exempt from tax under Section 501(c)(3) of the Internal Revenue Code.<sup>1</sup> Its main purposes are to advance legal research and to promote the administration of justice. It accomplishes these purposes by making grants to other charitable and educational groups (Pet. App. 26a). All members of the American Bar Association (ABA) are automatically members of the Endowment without paying additional dues. The two organizations, however, are separate legal entities (*id.* at 2a). The ABA is exempt from tax under Section 501(c)(6) as a "business league."

The Endowment was incorporated in 1942, and ABA members were encouraged to make gifts and bequests to it (Pet. App. 26a). Such charitable solicitations, however, generated only "sporadic individual donations" (*ibid.*). In order to raise more substantial sums for its educational endeavors, the Endowment in 1955 proposed "a fundraising plan \* \* \* based upon the sale of group life insurance" (*ibid.*). The *ABA Journal* promoted the program as a means by which members might "enjoy the satisfaction of contributing in a modest way" to the good of the legal profession and "at the same time \* \* \* receive low-cost life insurance protection" (C.A. App. 1395). The ABA also hoped that members would make charitable contributions to the American Bar Foundation, another ABA affiliate, by naming it as a beneficiary of such life insurance policies. The Foundation, however, has never received substantial sums from that source (J.A. 244-245; C.A. App. 1394-1395).

From modest beginnings, the Endowment's insurance operations have grown in size and importance (Pet. App.

<sup>1</sup> Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax periods in issue (the Code or I.R.C.).

27a). It offers life, health, accident, and disability coverage underwritten by major insurance companies. Coverage for members' dependents is also available under some plans (*ibid.*). The life insurance plan, the most heavily subscribed, had \$2.75 billion of insurance outstanding in 1980. More than 57,000 ABA members—about one-fifth of the total membership—were enrolled in one or more of the plans in that year. A total of 111,260 insurance certificates were then in force (J.A. 93).

The Endowment maintains a staff of 40 people to administer its insurance plans (Pet. App. 27a). It actively supports and officially endorses coverage under the plans, and solicits its members' enrollment through aggressive advertising prepared and distributed by its staff (J.A. 91, 530). It sends promotional literature about its plans to ABA members every year, generating a total of some 1.5 million mailings annually (J.A. 222, 234-236; C.A. App. 1063). These brochures describe the insurance plans in an easy-to-read format, typically referring to the premium charges as "reasonable," "attractive," "affordable," "economic," or "modest" (J.A. 239-240, 241; C.A. App. 988-1012, 1226-1268). According to the Endowment's literature, its disability coverage is "an exceptional insurance value for professional men and women" (*id.* at 1245); its accidental death coverage is "one of the finest values in broad-range accident insurance" (*id.* at 1236); and its major medical plan is "a wise investment in family security" in a time of "soaring" hospital costs (*id.* at 1248-1249).

In addition to these marketing activities, the Endowment's staff performs many tasks essential to administration of the insurance program. It negotiates premium rates with underwriters, negotiates commissions paid to insurance brokers, screens members' application forms, issues certificates of coverage, answers telephone inquiries, maintains files on participating members, bills and collects premiums, forwards premiums to the underwriters, and screens members' claims for benefits (Pet. App. 27a-29a; J.A. 91-92). Nearly all of the Endowment's operat-



ing budget, and between 80% and 85% of its staff's working hours, are devoted to these administrative and promotional activities (J.A. 90, 256).

The Endowment's contracts with its underwriters require the latter to calculate and refund annually to the Endowment, as group policyholder, any policy dividends or retrospective rate credits that accrue to the group policies (J.A. 75-76, 82). These sums, which we shall refer to collectively as "dividends," reflect the excess of the premiums paid by ABA members over the actual cost of coverage—in terms of claims settlement, administrative expenses, and profits—to the underwriters (Pet. App. 3a). In order to enroll in the program, every insured must waive any claim to receive these dividends and must consent to their retention by the Endowment. This condition is stated on the insurance application forms, and the Endowment insists on its strict enforcement (*id.* at 3a-4a, 32a; J.A. 293-295; C.A. App. 1128). When one insured struck the dividend waiver clause from his application form, the Endowment told him that he could not get insurance without accepting the same terms as everybody else (J.A. 293-295; C.A. App. 1135).

The policy dividends that the Endowment receives are the exclusive means of compensating it for the role it plays in marketing and servicing the insurance plans. It applies the dividends, net of its administrative and promotional expenses, to fund its educational projects. Every year, it calculates the percentage of the overall premiums that has been thus applied, and notifies its insured members that they may, in the opinion of the Endowment's counsel, deduct corresponding portions of their own premiums as tax-deductible charitable contributions (Pet. App. 4a, 32a-33a; C.A. App. 867-871). The Endowment's annual reports likewise publicize the insurance program "as a source of charitable contributions" (Pet. App. 36a).

The Endowment's strategy is to maximize the policy dividends and thus maximize its profits. Because ABA members enjoy very favorable mortality and morbidity experience, and because the Endowment negotiates with

the underwriters to make the plans experience-rated, the Endowment could, if it chose, offer insurance at very low premiums, perhaps at rates approaching the cheapest available for group insurance in the country (Pet. App. 30a-32a, 38a; J.A. 189, 220). The underwriters themselves would prefer that members be charged relatively low premiums, with concomitantly small dividends to the Endowment, in the hope of attracting the greatest possible number of participants (Pet. App. 28a). However, while setting the premium charges is technically the prerogative of the underwriters, the Endowment in practice plays a significant role in determining those rates (*ibid.*). The Endowment prefers to set premiums at levels well above the wholesale insurance cost, yet not so high as to discourage participation, so as to maximize the total volume of dividends that it will receive (*id.* at 28a-29a).

In pursuit of this dividend-maximizing strategy, the Endowment uses its leverage with the underwriters to assure that the gross premiums paid by ABA members are comparable to the rates charged for other insurance products available to those individuals in the marketplace (Pet. App. 3a-4a, 27a-30a, 32a). The Endowment regularly reviews the market comparability of its prices and benefits and adjusts its premiums from time to time to keep them competitive (*id.* at 3a, 29a). In 1978, the Endowment conducted a study that compared its premium rates with the prices charged for group insurance offered by state and local bar associations, legal fraternities, alumni organizations, and similar groups (C.A. App. 1378-1384). The study showed that the Endowment's prices, comparatively speaking, were very favorable to the insureds (*ibid.*). In 1980, the Endowment reviewed its rates for hospital and disability coverage and concluded that "[t]he present premium \* \* \* is competitive in the market place and the dividend is excellent, thus fulfilling the purpose of the Endowment to raise funds" (*id.* at 1120, 1121). Based on the recommendation of its underwriter, however, the Endowment concurrently lowered its rates for life insurance so as to "make the life plans com-



petitive in today's market" (J.A. 169, 191-192; C.A. App. 1074-1080, 1119). The Endowment thus takes pains to maintain its premiums within the market range, generating large dividends for itself yet keeping its insurance plans popularly priced (Pet. App. 3a-4a, 28a-29a; J.A. 127-128; C.A. App. 1279, 1282). Any plan not expected to generate large dividends in the long run is discontinued, regardless of its popularity (Pet. App. 32a).

The use of prevailing market rates, coupled with the favorable mortality and morbidity experience of ABA members, has made the Endowment's insurance operations highly profitable. The amounts refunded to it as dividends sometimes exceed 40% of the premiums its members pay (Pet. App. 4a). Income from its insurance operations is by far the major source of its revenue (C.A. App. 1326). Apart from policy dividends and investment income, the only income that the Endowment received during the tax years at issue consisted of charitable contributions to its "memorial fund." These contributions ranged from \$395 to \$1,495 annually. See C.A. App. 1319. The Endowment's gross insurance revenues, by contrast, aggregated almost \$19 million during that period (J.A. 82).

2. The individual respondents are ABA members who bought insurance from the Endowment (Pet. App. 31a, 38a).<sup>2</sup> Each agreed, as a condition of enrollment, that the Endowment could keep any dividends apportioned to his policy (*ibid.*). Each knew, when he wrote his premium checks, that the Endowment would use the dividends to further its work in the legal field.

Respondents Turner and Sherwood signed up for life insurance in 1972. They enrolled after reading brochures explaining that the Endowment's insurance program raised money for educational purposes while offering attractive insurance benefits at a reasonable cost (J.A. 271-273, 277-278; C.A. App. 1027-1034, 1040-1047). The

<sup>2</sup> Respondents' wives are parties solely by virtue of having filed joint income tax returns with their husbands for the relevant tax years.

brochures principally described the "highlights" of the coverage that the Endowment offered for sale, including the option granted to members under 40 (as Turner and Sherwood then were) to be accepted without medical evidence of insurability (*ibid.*).

Respondent Broadfoot initially purchased life insurance in 1971 because, as he testified, "[m]y first child had recently been born and I was interested in obtaining some life insurance" (J.A. 260). He regarded the premiums charged as reasonable, although not necessarily the cheapest on the market (*id.* at 263-264, 269-270). He had once carried a life policy through the Georgia State Bar, but discontinued it after determining that it cost more than the Endowment's (*id.* at 265-267).

Respondent Boynton purchased disability insurance in 1978 (C.A. App. 74). He received promotional literature from the Endowment recommending the disability plan as a "hedge against the constant risk of income loss through disability, \* \* \* with the economy of group rates" (J.A. 285-286; C.A. App. 1233). He concluded after reading the Endowment's literature that its disability coverage was "reasonably or competitive[ly] priced" (*id.* at 287). Before applying for his policy, he examined a number of other disability plans. He found that two offered greater benefits than the Endowment's, but were more expensive (*id.* at 285, 286).

None of the individual respondents testified that, if given an option, he would have elected to assign his policy dividends to the Endowment. None testified that he chose the Endowment's coverage over a cheaper policy in order to further the Endowment's educational goals. None testified that he thought the gross premiums charged by the Endowment exceeded the economic value of the insurance he purchased.

Two nonparty insureds testified that they would have opted to keep their dividends if that election had been offered to them (J.A. 391-392, 393, 454-455). One said that he purchased insurance from the Endowment because he found its premiums competitive and because he

thought that the Endowment "would certainly have the clout to deal with the insurance company" (*id.* at 453). He had personally urged the Endowment to make its insurance even cheaper by returning policy dividends to its members, but he found that the dividend assignment "was not an optional thing. You either agreed to that or didn't get the insurance" (*id.* at 448; C.A. App. 1276, 1277). The other nonparty insured testified that his sole motive for signing up was to obtain insurance (*id.* at 389-392). He chose the Endowment's plan because he did not need to take a medical exam to apply and because he considered the price of the insurance to be reasonable. Like respondent Broadfoot, he had previously held through his state bar association a group life policy that cost more than the Endowment's (*id.* at 389-392, 393, 511-512).

#### B. The Proceedings Below

1. Sections 511 through 513 of the Internal Revenue Code impose a tax, at regular corporate rates, on the "unrelated business taxable income" of otherwise tax-exempt groups like the Endowment. The tax applies to the net income "derived by any organization from any unrelated trade or business \* \* \* regularly carried on by it" (I.R.C. § 512(a)(1)). An "unrelated trade or business" is one "the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other [tax-exempt] purpose" (I.R.C. § 513(a)). Section 513(c) defines "the term 'trade or business' [to] include[] any activity which is carried on for the production of income from the sale of goods or the performance of services."

During 1979-1981, the tax years at issue, the Endowment's gross revenues from its insurance operations aggregated about \$19 million (J.A. 82). On audit, the IRS determined that those revenues, less the Endowment's expenses of promoting and administering the insurance program, were subject to tax as "unrelated business in-

come" (J.A. 83, 90).<sup>3</sup> The Commissioner determined tax deficiencies of approximately \$6 million for the three years (*id.* at 83-85).

The Endowment paid the asserted deficiencies and, following denial of its administrative claims for refund, instituted this refund suit in the Claims Court. It conceded that its insurance operations were "regularly carried on" and that the conduct of those operations was "not substantially related" to the achievement of its educational goals (I.R.C. §§ 512(a), 513(a)). See J.A. 94. The Endowment's sole contention was that its insurance operations were not a "trade or business" (I.R.C. § 513(c)). This contention was based on the theory that its insurance activities were not "carried on for the production of income from the sale of goods or the performance of services" (*ibid.*), but rather were carried on as a mere adjunct of charitable fundraising. According to the Endowment, its net insurance revenues were the product of "charitable contribution[s]" that ABA members made by "foregoing the advantage of having premium refunds returned to them" (J.A. 26, 27-28).

2. Section 170(a) of the Code provides an income tax deduction for "charitable contribution[s]." Section 170(c)(2)(B) defines a "charitable contribution" as "a contribution or gift" to or for the use of an entity that is "organized and operated exclusively for religious, charitable \* \* \* or educational purposes." Because the Endowment is tax-exempt under Section 501(c)(3), it is eligible to receive tax-deductible charitable contributions.

None of the individual respondents originally deducted any part of the insurance premiums that he paid the Endowment during 1979-1981 as a "charitable contribution" on his tax return (J.A. 50-52; C.A. App. 64-66, 76-78, 86-89). Thereafter, respondents were invited, and agreed, to take part in this "test case" being mounted

<sup>3</sup> Since the Endowment devoted its profits to charitable purposes, it was allowed a charitable contribution deduction equal to 5% of its "unrelated business taxable income," the maximum amount then permitted. See 26 U.S.C. (1976 ed.) 512(b)(10).



by the ABA (J.A. 273-274, 284). Each filed an administrative claim for refund, claiming a charitable contribution deduction ranging from 28% to 55% of the premiums he had paid. These percentages depended on the year and type of insurance involved, and were derived from notices issued to respondents by the Endowment (*id.* at 262-263, 272-273, 278-280, 282-283; C.A. App. 868-871). Each sought a refund of \$40 or less (J.A. 50-52; C.A. App. 64-66, 76-77, 86-89).

When the IRS demurred, respondents instituted these refund suits in the Claims Court. They contended that each premium they paid to the Endowment was a "dual payment," representing in part the purchase of insurance and in part a charitable contribution (Pet. App. 48a). In computing the charitable-contribution component of each alleged "dual payment," respondents contended that the value of the insurance they bought should be deemed to equal the wholesale insurance price (net of policy dividends) charged by the underwriters, plus the Endowment's out-of-pocket administrative and promotional expenses. Respondents contended, in other words, that they had made charitable contributions in an amount equal to the policy dividends that they were required to waive as a condition of purchasing the insurance, minus their allocable share of the costs incurred by the Endowment.

3. a. The refund suits filed by the Endowment and by the individual respondents were consolidated for trial and decision in the Claims Court. It entered judgment for the government on the charitable contribution issue, holding that none of the individual respondents was entitled to deduct any portion of his premiums (Pet. App. 48a-58a). An insured's "mere awareness" that the Endowment's insurance profits were destined for charitable purposes, the court ruled, was "not sufficient to establish that he made a charitable contribution" (*id.* at 52a). Rather, "[t]o establish a dual payment, the taxpayer must demonstrate that he bought goods or services for more than their economic value, with the intention that the excess be used to benefit [the] charitable enterprise"

(*id.* at 49a). "A corollary to this rule," the court said, "is that there can be no dual payment where the entire amount paid by the taxpayer is economically motivated, that is, where the payment is made to obtain goods or services for which the taxpayer would be willing to pay the full price even absent the charitable contribution" (*ibid.*). Under this standard, the court held, each respondent had to show "that an equivalent insurance product was available to him for a lower price and that he by-passed that product because he wished to make a charitable contribution to the Endowment" (*id.* at 52a (footnote omitted)).

Turning to the facts of the four respondents' cases, the Claims Court concluded that none of them had proved that his purchase of insurance from the Endowment reflected anything other than his own economic interest (Pet. App. 52a-54a). Three of the respondents, the court found, had failed to establish that cheaper insurance was available to them elsewhere (*ibid.*). The fourth, while demonstrating that cheaper insurance existed, offered no proof that he knew about it during the tax years at issue and had elected, for charitable reasons, to buy the Endowment's policy instead (*id.* at 55a-56a). The court noted that the Endowment's advertising was "aggressive" and "in some ways suggested [that its insurance] may be the best deal in the market" (Br. in Opp. App. B14), facts that may have lessened the incentive for ABA members to do exhaustive comparison shopping.

b. While ruling that the individual respondents could not deduct their premiums, the court held that the Endowment's insurance profits were immune from unrelated business income tax on the ground that they did not arise from a "trade or business" (I.R.C. § 512(a)). The statute, the court said, required it "to determine whether [the Endowment was] raising money 'from the sale of goods or the performance of services' or whether the goods or services [were] provided merely as an incident to a fundraising activity" (Pet. App. 34a, quoting I.R.C. § 513(c)). The court held that three factors, taken



together, pointed conclusively in the latter direction (Pet. App. 40a). First, the Endowment's insurance program "was devised as a means for fundraising" and was "so presented and perceived from its inception" (*id.* at 35a). The Endowment's promotional brochures, the court observed, "consistently referred to [its] retention of dividends as donations, not as profits," and it regularly "discussed the insurance program as a source of charitable contributions" (*id.* at 36a).

"Another significant factor," the court said, was "the staggering amount of money consistently generated" by the Endowment's insurance operations (Pet. App. 36a). The court found that these sums were "wholly unrelated to the value of any service [that the Endowment] provided and \* \* \* dwarfed the profit margins of [typical] insurance-related businesses" (*id.* at 40a). "[S]uch profit margins," the court believed, could not "be maintained year after year in a competitive market" (*id.* at 37a).

"The final and most telling factor," in Judge Kozinski's view, was that "the insurance program was operated with the approval and consent of the ABA membership" (Pet. App. 38a). The court noted that the ABA's 300,000 members collectively had the power, by mounting a "grassroots movement" to oust the current leadership, "to change the method of operating the insurance programs" so that members would get the policy dividends back, leaving the Endowment with no profits whatsoever (*id.* at 39a). The most rational explanation of why the membership refrained from doing this, and instead "permitted the Endowment to collect exorbitant revenues," was in the court's view that ABA members "consider the Endowment to be engaged in fundraising, which they support" (*id.* at 41a, 42a). The court emphasized that the Endowment sold insurance exclusively to its members and their dependents, so that the insurance transaction was one "where both buyer and seller are consenting in the sense that one controls the other" (Br. in Opp. App. A11). "[T]he idea of profiting from oneself," the court said, "is almost a contradiction in terms" (*id.* at A13).

The Claims Court accordingly held that "an enterprise that depends on the consent of its customers for its profits is not operating in a commercial manner and is not a trade or business" (Pet. App. 41a).

4. a. The court of appeals affirmed "on the basis of Chief Judge Kozinski's opinion" (Pet. App. 9a) the holding that the Endowment's insurance profits were exempt from tax. It concluded that the Claims Court had "properly found facts" and had "applied the correct standard" to determine whether the Endowment's insurance operations were a "trade or business" (*ibid.*). Based on "the persistent and fundamental fund-raising motivation" of the Endowment's insurance program, "the knowledgeable approval of and consent to the program by the ABA's members," and the Endowment's "phenomenal success" in accumulating policy dividends, the court of appeals was persuaded that the Endowment's activities were not "commercial" and thus were immune from tax (*id.* at 8a-9a). The fact that the Endowment "set out to make as much 'profit' as possible" did not in the court's view determine whether its insurance activities were a "trade or business" (*id.* at 11a). "Unlike what some other courts may do," the court of appeals observed, "this court does not find 'profits,' or the maximization of revenue, to be the controlling basis for a determination of whether the unrelated business tax provisions apply" (*ibid.* (footnote omitted)).

b. On the charitable contribution issue, the court of appeals reversed the Claims Court's judgment and remanded the cases with instructions. It held that the inquiry conducted by the trial court—whether respondents could have obtained comparable insurance coverage for less money—was "an incorrect definitization of the proper standard" (Pet. App. 19a). The Claims Court's approach was wrong, the court of appeals said, because it required affirmative proof of "a charitable motivation of disinterested generosity" (*id.* at 20a (footnote omitted)). The correct legal test, rather, in the court of appeals' view, was "whether the transaction between the

Endowment and the taxpayers \* \* \* was of a business nature and not charitable" based on "all the pertinent circumstances" (*id.* at 21a (original quotation marks omitted)). The court suggested that many ABA members may have signed up for the Endowment's insurance program so that "they could accommodate their insurance needs and at the same time substantially support a worthy charitable goal" (*id.* at 22a). For insureds who fit that description, the court said, it "should not be too difficult" to qualify for a charitable deduction (*ibid.*).

Finding the record "almost completely bare" as to the nature of respondents' dealings with the Endowment, the court of appeals remanded their cases for another trial. Given "the Endowment's persistent and public efforts to enhance its charitable funds," the court said, members who bought insurance from it should be able "to present a *prima facie* case" for a charitable deduction "simply [by] mak[ing] a sworn assertion that they wanted to aid that charitable endeavor and entered the Endowment's plan because it enabled them to do so" (Pet. App. 22a). The government would then have the burden to "controvert that position and [to] suggest factors showing that the transaction was basically business-oriented" (*ibid.*).

On July 17, 1985, the court of appeals stayed proceedings on remand pending this Court's disposition of these cases.

#### SUMMARY OF ARGUMENT

1. The taxability of the Endowment's insurance activities depends on whether those activities are a "trade or business." Section 513(c) defines a "trade or business" to include "any activity which is carried on for the production of income from the sale of goods or the performance of services." The legislative history makes it clear that Congress intended the term "trade or business" specifically to include a tax-exempt organization's operation of a group insurance program for its members.

The Endowment's insurance activities clearly satisfy each element of the definition set forth in Section 513(c).

First, those activities comprise both "the sale of goods" and "the performance of services." The Endowment sells various insurance products at retail and performs a variety of ancillary promotional and administrative services. Second, the Endowment carries on its activities "for the production of income," that is, to make a profit. The courts below correctly found that the Endowment's insurance activities are highly profitable and are consciously structured to be so. Third, the Endowment carries on its activities in order to make a profit "from" the insurance goods that it sells and "from" the insurance services that it performs. It was for the express purpose of profiting therefrom that the Endowment in 1955 proposed "a fundraising plan \* \* \* based upon the sale of group life insurance" (Pet. App. 26a). Because the Endowment sells insurance at fair market retail prices, and because it requires members to waive any claim to policy dividends as a condition of buying the insurance, the money that it makes necessarily arises "from" its insurance operation.

The Endowment's insurance operation, moreover, falls squarely within the policy of the unrelated business income tax. By marketing its insurance "as a source of charitable contributions" (Pet. App. 36a), the Endowment encourages ABA members to buy insurance from it, rather than to buy comparably-priced insurance from its competitors, on the theory that the after-tax cost of its insurance is substantially lower. In thus seeking to exploit its tax-exempt status to the detriment of other vendors of insurance in the marketplace, the Endowment exemplifies the very problem of "unfair competition" (H.R. Rep. 2319, 81st Cong., 2d Sess. 36 (1950)) at which the unrelated business income tax was aimed.

2. To be entitled to deduct a portion of their insurance premiums as a "charitable contribution," the individual respondents were required to prove (a) that the gross premiums they paid the Endowment exceeded the fair market retail value of the insurance they received in exchange, and (b) that they paid such "excess" with the



intention of making a gift. The Claims Court correctly held that respondents had failed to carry their burden of proof in one or both respects. Respondents' argument in essence was that the "value" of the insurance they bought should be deemed to equal, not its fair market retail value, but its cost to the Endowment. That is not, and has never been, the law.

The Federal Circuit, while accepting the Claims Court's basic findings of fact, concluded that respondents might nevertheless claim a deduction based simply on the assertion that they intended to support a worthy charitable goal, while at the same time accommodating their own insurance needs. That conclusion was erroneous, for it ignores the substantial economic equivalence between what respondents paid for and what they got.

#### ARGUMENT

#### I. INCOME DERIVED BY A CHARITABLE ORGANIZATION FROM MARKETING AND ADMINISTERING A GROUP INSURANCE PROGRAM FOR ITS MEMBERS IS SUBJECT TO TAX AS UNRELATED BUSINESS INCOME

##### A. The Term "Trade or Business" Includes Any Activity Regularly Carried On With The Intention of Making A Profit From The Sale Of Goods Or The Performance Of Services, And Congress Intended That This Definition Would Embrace Insurance Activities Of The Type Carried On By Respondent

1. The background of the unrelated business income tax, explained more thoroughly in our brief in *United States v. American College of Physicians*, No. 84-1737, may be summarized here. Before that tax was enacted, charitable organizations that carried on ordinary trades or businesses were able to escape tax on their profits on the theory that the charitable "destination" of the revenues took precedence over their commercial "source." Thus, a nationwide vendor of macaroni (*C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951)), and a commercial bathing beach facility (*Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938)), success-

fully claimed tax-exempt status simply because their business profits went to charity.

In 1950 Congress responded to that situation in two ways. First, it enacted the so-called "anti-feeder" provision (I.R.C. § 502(a)), which precludes organizations "operated for the primary purpose of carrying on a trade or business for profit" from claiming tax exemption solely on the ground that their profits go to charity. Second, Congress enacted the "unrelated business income tax," now codified in Sections 511 through 515 of the Code. Those provisions generally require any organization that otherwise qualifies for tax exemption to pay tax at regular corporate rates on income derived "from any unrelated trade or business \* \* \* regularly carried on by it" (I.R.C. § 512(a)(1)).

The chief impetus behind the new tax was Congress's desire to put the business operations of tax-exempt organizations on an equal footing with those of their tax-paying commercial counterparts. The House Report stated that "[t]he problem at which the tax on unrelated business income is directed \* \* \* is primarily that of unfair competition." H.R. Rep. 2319, 81st Cong., 2d Sess. 36 (1950). The tax generally falls on business revenues, not on membership dues or investment income, because Congress regarded such passive sources of funding as a traditional and proper mainstay for charitable institutions, one that was "not likely to result in serious competition for taxable businesses" (S. Rep. 2375, 81st Cong., 2d Sess. 30-31 (1950)).

The unrelated business income tax, as enacted in 1950, did not include a definition of the term "trade or business." The legislative history made clear, however, that the phrase "has the same meaning as it has elsewhere in the [C]ode, as, for example, in [the predecessor of Section 162(a)]," which authorizes deductions for expenses incurred in "carrying on any trade or business." See H.R. Rep. 2319, *supra*, at 109; S. Rep. 2375, *supra*, at 106. The indicia of a "trade or business" for purposes of Section 162(a) have always included the regularity, continuity and extensiveness of the taxpayer's commercial activities. See, *e.g.*, *McDowell v. Ribicoff*, 292 F.2d 174,



178 (3d Cir. 1961). "It is well established," however, "that the existence of a genuine profit motive is the most important criterion for the finding that a given course of activity constitutes a trade or business." *Lamont v. Commissioner*, 339 F.2d 377, 380 (2d Cir. 1964) (citing cases). Accord, e.g., *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963); *Besseney v. Commissioner*, 379 F.2d 252, 256 (2d Cir. 1967); *Iowa State University v. United States*, 500 F.2d 503, 522 (Ct. Cl. 1974).

In 1967, the Treasury promulgated regulations defining a "trade or business" for purposes of the unrelated business income tax. Treas. Reg. § 1.513-1, 32 Fed. Reg. 17657 (1967). The regulations stated that any activity "which is carried on for the production of income and which otherwise possesses the characteristics required to constitute [a] 'trade or business' within the meaning of section 162 \* \* \* presents sufficient likelihood of unfair competition to be within the policy of the tax" (Treas. Reg. § 1.513-1(b)). "Accordingly," the Treasury concluded, "for purposes of section 513 the term 'trade or business' has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services" (*ibid.*).

These regulations provoked considerable controversy, chiefly because they permitted a tax-exempt group's activities to be "fragmented" into unrelated-business and exempt-purpose components. See U.S. Br. at 15-24, *United States v. American College of Physicians*, No. 84-1737. Congress resolved this controversy in 1969 by codifying the regulations' definition of "trade or business." Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 *et seq.* Congress explicitly stated its intention "to make clear that such regulations are valid" and its determination that they "should be placed in the tax laws." H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1, at 44 (1969); S. Rep. 91-552, 91st Cong., 1st Sess. 75 (1969). Effectuating that aim, Congress in 1969 added to the Code a new Section 513(c). It provides that, "[f]or purposes of this section, the term 'trade or business' includes any activity which is carried on for the production of income

from the sale of goods or the performance of services." Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(c), 83 Stat. 542.

2. The legislative history of Section 513(c) itself sheds little light on the types of activities (aside from commercial advertising) that Congress believed would constitute a "trade or business" as there defined. In discussing related provisions of the 1969 Act, however, Congress had occasion to address the conduct of insurance operations by various types of tax-exempt groups. The legislative history of those provisions makes it clear that Congress intended the term "trade or business" to include an organization's operation of a group insurance program for its members.

a. Prior to 1969, many categories of tax-exempt groups were not subject to the unrelated business income tax. Organizations so immune included churches, social welfare organizations, social clubs, fraternal beneficiary societies, and voluntary employees' beneficiary associations. See H.R. Rep. 91-413, *supra*, at 47. Congress found that the exclusion of these groups from the tax had led to abuses, such as "churches [becoming] involved in operating chains of religious bookstores, hotels, factories, \* \* \* parking lots, record companies, groceries, bakeries, cleaners [and] candy sales businesses" (*ibid.*). Congress accordingly determined to "extend[] the unrelated business income tax to virtually all exempt organizations" (*ibid.*). It did so by amending Section 511(a) of the Code. Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(a)(1), 83 Stat. 536.

Several categories of organizations to which the tax was thus extended, such as fraternal beneficiary societies, had long been specifically authorized by the Code to conduct insurance programs as part of their tax-exempt mission. This authorization had been accomplished by providing, in Section 501(c), that the tax-exempt function of such a group included "providing for the payment of life, sick, accident, or other benefits to [its] members \* \* \* or their dependents." See 26 U.S.C. (1964 ed.) 501(c)(8) (fraternal beneficiary societies), 501(c)(9) (voluntary employees' beneficiary associations). In

extending the unrelated business income tax to such groups, Congress took pains to make clear that the tax would not apply to their insurance activities, inasmuch as those activities were defined by statute to be "substantially related" to their tax-exempt goals. As the Senate Report put it (S. Rep. 91-552, *supra*, at 68):

The bill continues to exclude from unrelated business income earnings from businesses related to an organization's exempt function—such as the earnings received directly or indirectly from its members by a fraternal beneficiary society in providing \* \* \* insurance benefits for its members or their dependents. For example, if the fraternal beneficiary society directly provides insurance for its members and their dependents, or arranges with an insurance company to make group insurance available to them, the amounts received by the society from its members for providing, or from the insurance company for arranging, for this exempt function will continue to be excluded from the unrelated business income tax.

The House Report stressed the same point. "In extending the unrelated business income tax to virtually all exempt organizations," that Report stated, "the bill continues to exclude \* \* \* earnings from businesses related to an organization's exempt function—such as an insurance business run by a fraternal beneficial association for its members" (H.R. Rep. 91-413, *supra*, at 47).

This legislative history makes it clear that Congress, in enacting Section 513(c), contemplated that a tax-exempt group's operation of an insurance program for its members would come within the term "trade or business" as there defined. As noted above, both the House and the Senate Reports explicitly refer to such insurance activities as a "business." H.R. Rep. 91-413, *supra*, at 47; S. Rep. 91-552, *supra*, at 68. Obviously, if Congress had intended that insurance activities *not* be deemed a "trade or business," it could have said that insurance income in general would be immune from tax for that reason. Instead, Congress limited its discussion to those tax-exempt groups that Section 501(c) expressly authorizes to provide insurance, and stated that those groups' insurance in-

come would be immune from tax because it was derived from "substantially related" activities. The unmistakable inference is that running an insurance program for members is a "trade or business," and that, if the conduct of that business is not "substantially related" to the group's tax-exempt purpose—as in the Endowment's case it concededly is not—the insurance income is subject to tax.

b. The conclusion that Congress regarded insurance operations as a "trade or business" is further supported by actions it took a few years later. Congress recognized in 1972 that the 1969 Act had unintentionally created a problem for veterans' groups, some of which "provide[d] one or more types of insurance for their members and the dependents of their members." S. Rep. 92-1082, 92d Cong., 2d Sess. 2 (1972). As the Senate Report noted (*ibid.*), the insurance programs of veterans' groups took several forms:

In some cases the organizations serve as commissioned agents for insurance companies which provide the actual insurance for the organizations' members and their dependents. In such a case, the organization receives portions of the premiums paid by its members for the insurance. In other cases, veterans' organizations receive income from their own provision of insurance benefits for their members and dependents, that is, they are self-insurers.

As of 1969, veterans' organizations were not specifically enumerated in Section 501(c) as a distinct category of tax-exempt group. Rather, they typically qualified for tax exemption as a "social welfare organization" under Section 501(c)(4), or as a "social club" under Section 501(c)(7). See S. Rep. 92-1082, *supra*, at 2. The tax-exempt purposes of groups in those two categories, of course, had never been defined to include the conduct of insurance programs. Since veterans' groups thus lacked any obvious basis for contending that their insurance operations were "substantially related" to their exempt functions, the 1969 Act appeared to subject their insurance profits to unrelated business income tax (S. Rep. 92-1082, *supra*, at 2-3).



Congress responded to this problem in 1972. Act of Aug. 29, 1972, Pub. L. No. 92-418, 86 Stat. 656 *et seq.* Congress noted that, under the 1969 Act, "income from insurance activities of fraternal beneficiary associations would be exempt from the unrelated business income tax," and it concluded "that there was no reason not to provide similar treatment for \* \* \* veterans' organizations" (S. Rep. 92-1082, *supra*, at 3). Congress accordingly added a new Section 501(c)(19) to the Code, specifically listing veterans' groups, for the first time, as a distinct category of tax-exempt group. Pub. L. No. 92-418, § 1(a), 86 Stat. 656. Congress then established "a special rule for \* \* \* veterans' organizations for the income they receive from providing insurance benefits" (S. Rep. 92-1082, *supra*, at 5). This "special rule" was accomplished by adding Section 512(a)(4) to the Code, defining the "unrelated business taxable income" of a veterans' group to exclude "any amount attributable to payments for life, sick, accident, or health insurance with respect to [its] members \* \* \* or their dependents." Pub. L. No. 92-418, § 1(b), 86 Stat. 656. See I.R.C. § 512(a)(4), cross-referring to I.R.C. § 501(c)(19). Finally, Congress determined that, since "there was no specific intent to tax the insurance income of veterans' organizations by the 1969 Act" (S. Rep. 92-1082, *supra*, at 4), the 1972 amendments should be made retroactive to December 31, 1969, the effective date of the 1969 legislation. Pub. L. No. 92-418, § 1(c), 86 Stat. 656.

These actions of Congress in 1972 confirm the conclusion that it regarded the insurance activities of tax-exempt groups as a "trade or business." Were that not so, there would have been no need to enact the 1972 legislation respecting veterans' groups at all. And unless Congress believed that the insurance profits of veterans' groups would have been subject to unrelated business income tax under a literal reading of the 1969 Act, Congress would scarcely have taken the rather unusual step of making the 1972 law retroactive to a date two years and nine months earlier.

**B. Because Respondent Engaged In A Regular And Extensive Course Of Commercial Activities With The Intent To Make A Profit, Its Insurance Operations Are A "Trade Or Business" And Its Insurance Income Is Subject To Tax**

1. In holding that the Endowment's insurance activities are immune from unrelated business income tax, the courts below ignored the plain language of Section 513(c), as well as the import of the legislative history just discussed. The statute unequivocally states that "the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services" (I.R.C. § 513(c)). The Endowment's insurance activities satisfy each element of this definition.

First, the Endowment's insurance activities obviously comprise both "the sale of goods" and "the performance of services." The Endowment sells various insurance products at retail, including participation in group life, health, accident, and disability plans (Pet. App. 27a, 29a). And it performs valuable services first and foremost by putting together a group of above-average insurance risks, and then by selecting and negotiating with the underwriters, assembling a package of group policies, endorsing, promoting, and marketing that package to its members, screening its members' applications, answering their inquiries, billing and collecting their premiums, and discharging a host of other day-to-day tasks essential to the functioning of the program (J.A. 82-83, 90, 91-92). Indeed, its staff of 40 runs the business in much the same way that most insurance brokers, plan administrators, and other financial intermediaries run theirs.

Secondly, the Endowment carries on its insurance program "for the production of income," that is, in order to make a profit. Both courts below found that the Endowment's insurance program is highly profitable and that it is consciously structured to be so. The Endowment's strategy is "to operate only those insurance plans capable of generating substantial dividends" (Pet. App. 28a,



29a). The Endowment "assure[s] that the ABE insurance plans [are] experience rated," and it causes the underwriters to "set the premiums as high as possible without discouraging participation," so that it in turn can "benefit from the high dividends it c[an] recoup as a result of the generally favorable morbidity and mortality experience" of ABA members (*id.* at 4a, 28a-29a, 31a). The Endowment "gain[s] the benefit of the float on a portion of the premiums," it "avoid[s] charges for a certain type of [insurance] reserve," and it otherwise "use[s] the size and prestige of [its] account to vigorously negotiate the most advantageous possible cost structure for each of the insurance plans" (*id.* at 31a-32a). These facts show that the Endowment follows the same strategy "for the production of income" (I.R.C. § 513 (c)) that has been used by successful businesses since the beginning of time—"cutting costs" while "keeping gross premiums [as] high" as the market will bear (Pet. App. 28a, 31a-32a).

Finally, it is obvious, contrary to respondent's contention (Br. in Opp. 10-11), that the Endowment carries on its insurance activities in order to make a profit "from" the insurance goods that it sells and "from" the insurance services that it performs. It was for the express purpose of profiting therefrom that the Endowment set up the insurance program in 1955. For the first 13 years of its existence, the Endowment had tried to raise money by asking ABA members voluntarily to make charitable contributions to it. As the Claims Court found (Pet. App. 26a), however, these charitable solicitations generated only "sporadic individual donations." Having found itself unable to raise through charitable solicitations the volume of funds that it desired, the Endowment in 1955 proposed "a fundraising plan \* \* \* based upon the sale of group life insurance" (*ibid.*). In structuring that plan, the Endowment required ABA members, as an absolute condition of purchasing insurance, to waive any claim to policy dividends. If the Endowment had instead

consented to rebate the dividends to its members, coupling such rebates with a request that the members voluntarily contribute the dividends back to it, it would have a strong claim that funds thus contributed were derived "from" charitable solicitations rather than "from" its insurance business. Instead, the Endowment required members to waive their dividends, and it set their gross premiums "at a level competitive with other insurance on the market" (*id.* at 4a), so that the *entire amount* the members paid was a *premium* payment for *insurance*. Thus, whether one views the Endowment as ultimately being compensated by its members (via premiums) or by the underwriters (via dividends), the payments it receives are *insurance-related payments* that necessarily arise *from its insurance-related activities*.

In sum, the Claims Court's factual findings show that the Endowment, like any middleman, endeavors to and does earn profits from buying at wholesale, selling at retail, and rendering the ancillary services necessary to that sales operation. Those findings establish that the Endowment's insurance activities are "carried on for the production of income from the sale of goods or the performance of services" (I.R.C. § 513(c)). That fact, under the governing statute, compels the conclusion that respondent is in a "trade or business."

2. Consistently with what we believe to be the proper construction of Section 513(c), the Fourth, Fifth, and Sixth Circuits have held that a tax-exempt business league's operation of a group insurance program for its members is a "trade or business" if the program is carried on to earn a profit. See *Carolinas Farm & Power Equipment Dealers v. United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *Professional Insurance Agents v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984). The organizations involved in these cases were tax-exempt associations which, like the Endowment, drew their members exclusively from a single trade or profession. Like the Endowment, each operated a group in-

insurance program for its members, "serv[ing] as a middleman between [its] member[s] \* \* \* and commercial vendors of insurance" (*Louisiana Credit Union League*, 693 F.2d at 528). In its capacity as middleman, each association performed a variety of "promotional and administrative services" (*Professional Insurance Agents*, 726 F.2d at 1100). It selected the insurance underwriter; served as group policyholder; actively supported and officially endorsed the insurance program; distributed informational brochures to its members; answered members' telephone inquiries and otherwise marketed the program; processed its members' application forms and requests for changes in coverage; sent premium notices to its members, collected their premium checks, and forwarded the premiums to the underwriters; and generally "performed the day-to-day administrative tasks essential to the insurance \* \* \* operations." *E.g.*, *Louisiana Credit Union League*, 693 F.2d at 533. Like the Endowment, each association received substantial rebates from the insurance carriers, computed either as experienced-rated refunds or as a flat percentage of members' gross premiums. *Id.* at 528; *Professional Insurance Agents*, 726 F.2d at 1100-1101; *Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 168. Each association, like the Endowment, earned large amounts of insurance-related income, yet contended that its insurance activities did not constitute a "trade or business" within the meaning of Section 513(c).

The court of appeals in each case squarely rejected that argument. In *Louisiana Credit Union League*, the Fifth Circuit held that the key question under Section 513(c)'s definition of a "trade or business" is whether the organization "had a profit motive for its activities" (693 F.2d at 532-534). As the court put it (*id.* at 532):

We believe that the "profit motive" standard is the proper one to be applied in this case, for it is consistent with the plain language of section 513 as well as the accompanying regulations. The statute, which clearly encompasses within its parameters any activ-

ity "carried on for the production of income," first raises the issue of motive. The regulations, which invoke section 162 and its "profit motive" gloss, confirm that motive is the key inquiry. Thus, to determine whether a tax-exempt organization is carrying on a trade or business, the court must look to see whether that institution is engaged in extensive activity over a substantial period of time with the intent to earn a profit.

The record in that case indicated that the association had "extensive involvement in insurance \* \* \* activities" and that it engaged in them "primarily because [they] produced revenue necessary to finance [its] operations" (*id.* at 532-533). These facts, the Fifth Circuit explained, showed the existence of a "trade or business" (*id.* at 533):

[The association] did everything short of actually selling the insurance \* \* \* itself: it selected the companies whose products and services would be endorsed, actively marketed and promoted those products and services to [its] member[s] \* \* \*, and performed the day-to-day administrative tasks essential to the insurance \* \* \* operations. More comprehensive involvement would be difficult to imagine. As reflected by the [association's] receipts for the years in issue, [it] was amply rewarded for its efforts—its activities were highly profitable, and those profits were increasing. We agree with the district court that the [association] had the "profit motive" for its insurance \* \* \* activities necessary to a finding of a trade or business \* \* \*.

In *Carolinas Farm & Power Equipment Dealers*, the Fourth Circuit likewise held, on substantially identical facts, that "the proper inquiry is whether an organization conducts an activity to earn a profit. If so, the activity is a trade or business" (699 F.2d at 169). The court observed that the association "consistently received far more in rebates than it expended in providing insurance services" and that its insurance operations were "highly



profitable" (*id.* at 170). Where a tax-exempt group conducts commercial activities "in a competitive profit-seeking manner and regularly earns significant profits," the court held (*id.* at 171),

a heavy burden must be placed on the organization to prove [that] profit is not its motive. Certainly where, as here, an organization could easily rebate any profits to its members and thus \* \* \* provid[e] them with even lower cost group insurance, that burden must be held unmet.

In *Professional Insurance Agents*, the Sixth Circuit explicitly followed these decisions and held that Section 513(c) "requires us to examine the exempt organization's underlying reasons for engaging in the questioned activity. If it has as its motive the production of income, the activity constitutes a trade or business" (726 F.2d at 1102). The court of appeals examined the marketing, administrative, and promotional activities that the association had undertaken to support the insurance program, and concluded that it had "engaged in extensive activity over a substantial period of time with intent to earn a profit" (*ibid.*). The court accordingly held that the association's "motive for offering the insurance policies at issue \* \* \* was one of profit sufficient to support a finding that the premiums it received were from a trade or business" (*ibid.*).

3. In declining to follow these cases, neither the Claims Court nor the Federal Circuit contended that they were wrongly decided. Rather, both courts "found these cases to be inapposite, primarily because they involved insurance plans run by business leagues rather than charitable organizations" (Pet. App. 10a, 43a-44a). But this difference, upon which respondent also relies (Br. in Opp. 14-16), is wholly irrelevant to the issue at hand; the cases are for all intents and purposes indistinguishable.

a. Respondent appears to agree (Br. in Opp. 15-16) that the Fourth, Fifth and Sixth Circuit cases cannot be distinguished from this one on the purely formal ground that the groups selling insurance there were tax-exempt

as "business leagues" under Section 501(c)(6), whereas the Endowment is tax-exempt as an "educational association" under Section 501(c)(3). That concession is appropriate. As we have argued at greater length in *United States v. American College of Physicians* (84-1737 U.S. Br. at 33-40), the subsection of Section 501(c) under which a professional group happens to be organized makes no difference in determining the taxability of its profit-motivated activities. Section 513(c)'s definition of "trade or business" applies to *all* tax-exempt groups. Under that definition, it is the nature of the *activities* conducted by the group, not the source of its exemption, that determines whether it is in a "trade or business." Any formal distinction along these lines would be particularly inappropriate here, since the Endowment is a charitable affiliate of the ABA, which is *itself* a Section 501(c)(6) business league. Neither law nor logic could justify a theory under which the Endowment's insurance program would be a "trade or business" if run by the ABA, yet cease to be a "trade or business" because run by the Endowment. Such a theory would enable any tax-exempt group to avoid taxation of its business profits simply by spinning the business off into a Section 501(c)(3) sister corporation, a result that would make payment of the unrelated business income tax elective.

b. While correctly conceding that business leagues and charities should not "be treated differently for purposes of section 513 if they are operating in the same manner" (Br. in Opp. 15-16 (emphasis in original)), the Endowment argues that its mode of operation differs from that of the business leagues we have described. Respondent acknowledges, as it must, that its full-time staff of 40 perform during their working day substantially the same promotional, administrative and sales tasks whose aggregation the Fourth, Fifth and Sixth Circuits have held to be a "trade of business" (see *id.* at 12-14). But respondent says that the groups involved in those cases "performed services for an insurance carrier and [were] paid \* \* \* by the insurance carrier," whereas the Endow-



ment performed services for its members and was paid by them (*ibid.*).

This contention is wholly beside the point. Like the business leagues described above, respondent "serves as a middleman between [its] member[s] \* \* \* and commercial vendors of insurance." *Louisiana Credit Union League*, 693 F.2d at 528; Pet. App. 47a. Like those business leagues, respondent receives sizable rebates or dividends from the insurance carriers. Contrary to respondent's contention, it is immaterial who—as between the members and the underwriters—should be viewed as the "source" of this money in some ultimate economic sense. A middleman in the nature of things performs services for both the buyer and the seller; he may be paid by the buyer, the seller, or both. In determining whether he is in a "trade or business," it is irrelevant who remunerates him. The point is that the Endowment, like the business leagues we have discussed, sells a variety of insurance-related goods and performs a variety of insurance-related services, the result of which is that it receives, through a combination of payments from its members and its underwriters, a substantial volume of insurance-related income. Respondent is thus "operating in the same manner" (Br. in Opp. 16) in which those business leagues operated.

c. Finally, respondent follows the courts below (Pet. App. 10a, 44a) in seeking to distinguish the cases we have discussed on the ground that the groups selling insurance there, being "business leagues," were incapable of the "charitable fundraising" that respondent asserts to be the true source of its revenues. See Br. in Opp. 14-15. As the Claims Court put it, "Once it is shown that a 501 (c) (6) organization is engaging in an income-producing enterprise, the activity must *perforce* be deemed a business because such organizations do not engage in charitable fundraising" (Pet. App. 44a (emphasis added)).

This argument is illogical. It is of course true that a business league for its own purposes cannot engage in

charitable fundraising, because a business league is not a charity. But a business league is perfectly capable of engaging in fundraising for the various worthwhile purposes that constitute the basis of its tax exemption. See 4 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 102.3.2 (1981). The business leagues involved in the cases we have discussed thus had available to them the same argument—that their insurance operations were not a "trade or business" but were merely an adjunct of "tax-exempt fundraising"—that the Endowment makes here. Indeed, the Fifth and Sixth Circuits noted that the insurance operations of a Section 501(c)(6) group "are basically a fundraising activity," but they held that such activity is nonetheless an unrelated "trade or business." *Professional Insurance Agents*, 726 F.2d at 1104; *Louisiana Credit Union League*, 693 F.2d at 537.

**C. The Justifications Advanced By The Courts Below Do Not Support Their Decision To Exempt Respondent's Insurance Profits From Unrelated Business Income Tax**

The courts below adduced four principal arguments to support their conclusion that the Endowment is not running a "trade or business." First, they reasoned that the insurance program is "presented" by the Endowment and "perceived" by its members as "a fundraising activity" (Pet. App. 8a-9a, 35a-36a). Second, they said that the Endowment's profits are "astounding" and have "far exceeded the value of any services which it might have performed" (*id.* at 8a-9a, 36a-40a). Third, they reasoned that the Endowment needed the "consent to the program by the ABA's members" and that "an enterprise that depends on the consent of its customers for its profits \* \* \* is not a trade or business" (*id.* at 8a, 41a). Finally, they asserted that the Endowment's insurance venture has "an entirely procompetitive effect" and "does not represent the sort of enterprise at which the unrelated business income tax [is] directed" (*id.* at 9a, 47a-48a). There is no merit to any of these theories.

1. In determining whether the Endowment is running a "trade or business," it is legally irrelevant that its promotional materials "consistently refer[] to [its] charitable endeavors" and describe the insurance program as "a fundraising activity" (Pet. App. 36a). "Fundraising," after all, is just a synonym for "making money." Whenever a charity makes money, from an unrelated business or otherwise, its activity can be styled "charitable fundraising" because the income is destined for—indeed, must, if the charity is to retain its exemption, be used exclusively for—charitable purposes. The profits that NYU once made by selling spaghetti through its macaroni factory (*C.F. Mueller Co. v. Commissioner, supra*), could equally have been labeled "charitable fundraising," since the funds financed education.

It is likewise immaterial that the Endowment's members may approve of its charitable endeavors, may know that their premiums help finance those endeavors, and may choose its insurance over a comparably-priced competitor's because they want those endeavors to thrive. People who bought spaghetti from NYU's macaroni company rather than from its competition may well have known that part of their purchase price would "go to charity," and may well have been motivated by the thought that NYU would at least make good use of the money. But Congress in 1950 dictated the irrelevance of these facts by enacting the unrelated business income tax, which aims to prevent tax-exempt groups from gaining a subsidy to the detriment of their taxpaying competitors in the marketplace, and which accordingly focuses on the *source*, not on the *destination*, of a charity's income. The rationale of the courts below—that the Endowment's insurance profits represent "charitable fundraising"—simply begs the question, which is not whether the Endowment raises funds for charitable purposes, but whether it raises funds for charitable purposes by running a "trade or business." As commentators on the Claims Court's decision have noted, "the court's emphasis on the destination of the profits for charitable pur-

poses is wholly at variance with the genesis of the tax." Schwarz & Hutton, *Recent Developments in Tax-Exempt Organizations*, 18 U.S.F.L. Rev. 649, 684 (1984).

Finally, the fact that the Endowment "refer[s] to [its] retention of dividends as donations" and describes the insurance program "as a source of charitable contributions" (Pet. App. 36a), far from supporting a decision to immunize it from unrelated business income tax, points in precisely the opposite direction. By marketing the program in this way, the Endowment encourages ABA members to buy insurance from it, rather than to buy comparably-priced insurance from its competitors, on the theory that the *after-tax* cost of its insurance is substantially lower. In thus seeking to exploit its tax-exempt status to gain a competitive edge over other sellers of insurance in the marketplace, the Endowment exemplifies the very problem of "unfair competition" (H.R. Rep. 2319, *supra*, at 36) at which the unrelated business income tax was aimed.

2. The Federal Circuit's suggestion that the "phenomenal" and "astounding" profitability of the Endowment's insurance program *negates* its trade-or-business status (Pet. App. 8a) turns Section 513(c) on its head. The key criterion for assessing the existence of a "trade or business" under Section 513(c) is whether the organization has a genuine motive to earn a profit. One would have thought that a motive, successfully executed, to earn extraordinarily large profits by selling goods or services at competitive market prices would make an activity more of a trade or business, not less of one.

Contrary to the statements of the courts below (Pet. App. 8a, 37a), moreover, it is irrelevant that the Endowment generates its profits by realizing a high profit margin on its existing volume of sales, rather than by realizing a lower profit margin on what could be a much larger volume of sales. Economically speaking, the Endowment's insurance operation functions as a business set up to exploit a very valuable, but virtually cost-free, asset—a pool of potential insureds, all ABA members,



who have far-above-average mortality and morbidity experience. The Endowment could elect to exploit this asset in at least two ways, depending on its marketing strategy. It could charge below-market premiums, maintaining a modest level of profitability per insured but attracting a big market share. If it did that (as its underwriters surely wish it would), many more lawyers might join the ABA and buy insurance from the Endowment, since its premiums would be among the lowest anywhere. If the Endowment chose to run its insurance business in that way, it would make its profits (as do supermarkets) on volume, and would clearly—even under the decision below, presumably—have to pay unrelated business income tax on those profits.

Alternatively, the Endowment could elect, as it in fact did, to charge market-level premiums, maintaining a high level of profitability per insured but settling for a more modest market share. On this approach, some lawyers will decide to buy insurance elsewhere, the Endowment's prices being roughly equivalent—ignoring for the moment the Endowment's promise of a tax-deductible charitable contribution—to the prices charged in the marketplace generally. But the Endowment will make lots of money on the lawyers who pick it. That is what the Endowment has chosen to do, and it should pay tax on its profits just as clearly as if it had generated the same total amount of income by pursuing the high-volume, low-mark-up option discussed above.

It is also irrelevant, in determining whether the Endowment is running a "trade or business," that it may have "set premiums at levels significantly higher than necessary" to cover its costs (Br. in Opp. 6) and that its insurance profits may "have far exceeded the value of any services which it \* \* \* performed in the course of its administration of the plan" (Pet. App. 9a). To begin with, the Endowment's most valuable services are not the mechanical tasks of administering the plan, but its ability, acting as a middleman between suppliers and

consumers of insurance, to exploit its unique access to a pool of better-than-average insurance risks by endorsing, marketing and promoting the program. The group insurance plans involved in the Fourth, Fifth, and Sixth Circuit cases for similar reasons were also "highly profitable." See, e.g., *Louisiana Credit Union League*, 693 F.2d at 533. The association in *Professional Insurance Agents* incurred expenses of only \$12,000 to generate income of \$176,000 from its insurance plans. Noting the wide differential between the one figure and the other, the Tax Court reasoned that the association "was being compensated not so much for the administrative services it performed as it was for endorsing the insurance company's product and providing a direct pipeline to its membership." 78 T.C. 246, 262 (1982).

More fundamentally, the Federal Circuit's analysis confuses the perspectives of the seller and the retail buyer. Middlemen invariably mark up the goods or services they sell; that is how they make money. The principal constraint on a middleman's ability to make profits is the market; if he seeks too high a mark-up above his costs, customers will buy elsewhere. Since ABA members have no access to the wholesale insurance market, it makes no difference whether the Endowment's profits are "equal" in some abstract sense to the value of the services it performs in delivering coverage to them. The relevant question, rather, is whether the retail price that the Endowment charges for participation in its group insurance plan is within the range of prices for comparable insurance in the retail marketplace generally.

A trial was held to answer that question, and the Claims Court found that the Endowment's "gross premiums were set with reference to the rates for other insurance products available in the market" (Pet. App. 29a (footnote omitted)). The Federal Circuit agreed with that finding, noting that the Endowment "set the premium at a level competitive with other insurance on the market" (*id.* at 4a). These factual findings mean that the retail price paid by the Endowment's members was



equal to the fair market value of the insurance they purchased, and that the Endowment's insurance operation was "conducted in a competitive profit-seeking manner" (*Carolinas Farm & Power Equipment Dealers*, 699 F.2d at 171). It thus constitutes a "trade or business" under the "profit motive" standard mandated by Section 513(c).<sup>4</sup>

3. In deciding whether the Endowment was engaged in a "trade or business," the "most telling factor" in the Claims Court's view was that "the insurance program was operated with the approval and consent of the ABA membership" (Pet. App. 38a). The court noted that the ABA's 300,000 members collectively have the power, by mounting a "grassroots movement" to oust the current leadership, "to change the method of operating the insur-

<sup>4</sup> In holding that the Endowment's high profit margins indicated the absence of a "trade or business," the courts below viewed those profits as showing that the Endowment's insurance activities were not "operated in a competitive, commercial manner" within the meaning of the Court of Claims' earlier decision in *Disabled American Veterans v. United States*, 650 F.2d 1178, 1187 (1981). See Pet. App. 8a-9a, 34a. That case involved a tax-exempt group that mailed out low-cost "premiums," such as maps and wristwatch calendars, to stimulate contributions to its semi-annual fund drive. The Court of Claims held that the group was not engaged in a "trade or business" to the extent that the "contribution required for the \* \* \* premiums was substantially in excess of their retail value," with the retail value ranging from \$0.85 to \$1.50 (650 F.2d at 1187). In so ruling, the Court of Claims relied on Treasury Regulations providing that "where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply" (Treas. Reg. § 1.513-1(b)).

Putting aside the question whether *Disabled American Veterans* was correctly decided, the courts below erred in relying on it here. Contrary to those courts' statements, the Endowment's insurance business is run in a "competitive, commercial manner" (650 F.2d at 1187). The prices it charges do not exceed the retail value of the insurance its customers buy. And the Regulations' exception for "low-cost articles" obviously has no application to the Endowment's insurance operation, which in 1980 administered \$2.75 billion of life insurance alone.

ance programs" so that members would get the policy dividends back, leaving the Endowment with no profits whatsoever (*id.* at 39a). The most rational explanation of why ABA members refrain from doing this, the court stated, was that they "consider the Endowment to be engaged in fundraising, which they support" (*id.* at 41a, 42a). The court emphasized that the Endowment sells insurance exclusively to its members and their dependents so that the insurance transaction is one "where both buyer and seller are consenting in the sense that one controls the other" (Br. in Opp. App. A11). "[T]he idea of profiting from oneself," the court said, "is almost a contradiction in terms" (*id.* at A13). The Claims Court accordingly held that "an enterprise that depends on the consent of its customers for its profits is not operating in a commercial manner and is not a trade or business" (Pet. App. 41a).

This reasoning is multiply flawed. It is of course true that one cannot derive a "profit," economically speaking, from dealings with oneself. But the Endowment is a corporate entity distinct from its members, and there is by no means a complete identity of interests between them. The Endowment deals with its members, in their capacity as customers, in a business-like manner and at arm's length. It markets its insurance to them aggressively, and it sets the price of its insurance as high as it can without driving them away. It treats its market, in short, much as other profit-maximizing enterprises treat theirs. Had the Endowment requested its members individually to return their dividends as an act of generosity, it would have dealt with them as a charity. But when it requires them to waive their dividends as a condition of buying insurance, it deals with them as a business.

The fact that ABA members theoretically have the power, by mounting a "grassroots movement" (Pet. App. 41a), collectively to change the Endowment's profit-maximizing strategy makes no difference whatsoever. The reality is that only 20% of ABA members buy

insurance from the Endowment; the others presumably have insurance provided to them as a fringe benefit where they work, have found a better insurance deal elsewhere, or have chosen to do without insurance altogether. The 80% who do not buy the insurance presumably care little what the 20% are charged. Indeed, the 80% may well applaud the Endowment's educational endeavors and want those endeavors to be amply funded, particularly when the funds are provided by somebody else.

The prospect of a collective "grassroots movement" under these circumstances is utterly hypothetical. The Endowment sells insurance to *individuals*, not to an incorporate body politic. The Endowment sets the terms on which the insurance will be sold, and the individual member can take it or leave it. Given the cold facts and the business-like character of these relationships viewed individually, it makes no sense to say that, viewed collectively, they somehow add up to a sort of "group gift." See Br. in Opp. App. A6-A7.

The Claims Court's theory would open a loophole in the unrelated business income tax that Congress plainly has not sanctioned. The implications of the Claims Court's theory would not be confined to charitable organizations. The business leagues involved in the Fourth, Fifth and Sixth Circuit cases likewise sold insurance exclusively to their members, and thus "depend[ed] on the consent of [their] customers for [their] profits" (Pet. App. 41a). They would seem as well-situated as respondent to take advantage of the Claims Court's rationale. Nor would the application of that rationale be confined to sales of insurance. A tax-exempt organization could run hotels, apartment complexes, ski lodges, vacation resorts, travel agencies, and video sales outlets—ventures that would appear to all the world to be "a trade or business"—yet seek to avoid tax on its business profits by arguing that its customers were members who had the hypothetical power to "deny it any income if they so desired" (*id.* at 42a (emphasis omitted)). Nor is it self-evident why a

group would have to sell exclusively to its members in order to take advantage of the Claims Court's theory. Indeed, provided that a group's customer base included *some* members with the theoretical option to limit its profits, the group might sell to the world at large yet assert immunity from the unrelated business income tax.

The statute does not permit exempt organizations to conduct unrelated trades or businesses, yet escape tax on their profits simply by doing some or all of their business with their members. And insurance operations are no exception to this rule. To the contrary: the insurance operations of veterans' groups and fraternal beneficiary societies, which Congress addressed in 1969 and 1972, are invariably confined to providing insurance "to \* \* \* members \* \* \* or their dependents." I.R.C. § 501 (c) (8) and (19); see pages 19-22, *supra*. Yet Congress has made it clear that it regards such insurance activities as a "trade or business."

4. Contrary to the statements of the courts below (Pet. App. 9a, 45a-48a), finally, the Endowment's insurance activities fall squarely within the policy of the unrelated business income tax. Congress enacted that tax "to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete" (Treas. Reg. § 1.513-1(b)). The Endowment's insurance operation—involving the administration of billions of dollars in policies, and enjoying the patronage of some 57,000 ABA members—is big business, and it provides a staple that few of its members do without. The Endowment thus competes directly with insurance brokers, plan administrators, and financial intermediaries nationwide that vie for the trade of 300,000 ABA members. Even credit card companies, oil companies, and department stores that offer insurance to their customers are viewed by the Endowment as sources of competition (C.A. App. 1189-1190). The privilege of stepping into the Endowment's shoes, with direct access to the ABA membership, "would be of great interest to a commercial venture" (*id.* at



1069 (emphasis in original)). Indeed, the Endowment has received, but has rejected, the bid of a for-profit insurance brokerage firm to take over administration of its plans for an annual fee (J.A. 87; C.A. App. 1173-1183).

The fact that the Endowment forbears from under-selling all of its competitors, moreover, does not mean, as the Claims Court thought, that its insurance business has an "entirely procompetitive effect" (Pet. App. 48a). Quite the contrary: a tax-exempt entity need not under-price everyone else in the market to bring the policy of the unrelated business income tax into play. The incidence of that tax is premised, not upon a showing of predatory pricing in fact, but upon a statutory presumption that a tax-exempt group's operation of an "unrelated trade or business" presents a "sufficient likelihood of unfair competition to be within the policy of the tax" (Treas. Reg. § 1.513-1(b)). Indeed, given the market share that the Endowment's insurance program commands, it must be rather cold comfort to its competitors that its insurance could be even cheaper than it is. Particularly is that so since the Endowment exploits its tax-exempt status to gain an edge over its competition by telling its members that their premiums are partially tax-deductible.

## **II. RESPONDENTS ARE NOT ENTITLED TO DEDUCT ANY PORTION OF THEIR INSURANCE PREMIUMS AS A CHARITABLE CONTRIBUTION BECAUSE THEY FAILED TO PROVE THAT THE PRICE THEY PAID FOR THE INSURANCE EXCEEDED ITS FAIR MARKET VALUE**

### **A. A Transfer To A Charity Is Not A "Contribution" Or "Gift" If The Transferor Receives, Or Expects To Receive, Commensurate Economic Benefits In Return**

1. Section 170 of the Code affords an income tax deduction for a "charitable contribution," defined as "a contribution or gift" to or for a charitable, educational, or other qualifying group (I.R.C. § 170(c)(2)). The

phrase "contribution or gift" is not further defined in the Code or Regulations. However, Congress made clear in the legislative history of the 1954 Code that a transfer of property constitutes a contribution or gift "only if there [is] no expectation of any quid pro quo." H.R. Rep. 1337, 83d Cong., 2d Sess. A44 (1954). For purposes of the charitable contribution deduction, in other words, "gifts" are limited to "those contributions which are made with no expectation of a financial return commensurate with the amount of the gift." S. Rep. 1622, 83d Cong., 2d Sess. 196 (1954). See 2 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 35.1.3, at 35-7 (1981).

Drawing upon this legislative history, the courts of appeals have consistently denied charitable contribution deductions to taxpayers who expect to receive, or do receive, an economic quid pro quo commensurate with the value of the property they transfer to charity. In *Sedam v. United States*, 518 F.2d 242 (1975), the Seventh Circuit denied a charitable deduction for a donation to an old-age home, where the "gift" was required as a condition of admitting patients. "It is at least clear," the court held, "that a payment is not a contribution or gift under section 170 if it is made with the expectation of receiving a commensurate benefit in return" (518 F.2d at 245). In *Goldman v. Commissioner*, 388 F. 2d 476 (1967), the Sixth Circuit denied a charitable deduction for a payment to charity, where the taxpayer received in return a raffle ticket which carried a chance to win a prize. The court concluded that the taxpayer "got just what he paid for" and hence had not made "a charitable contribution within the meaning of the statute" (388 F.2d at 480). In *Stubbs v. United States*, 428 F.2d 885 (1970), the Ninth Circuit denied a charitable deduction for a developer's contribution of land to a municipality, where the transfer was made in the hope of obtaining favorable zoning treatment. The alleged gift did not qualify for deduction under Section 170, the court held, because it "was in expectation of the receipt of certain



specific direct economic benefits within the power of the [city] to bestow" (428 F.2d at 887). Indeed, the Federal Circuit's predecessor on previous occasions itself denied charitable deductions where "the transferee had received, or expects to receive, a *quid pro quo* sufficient to remove the transfer from the realm of deductibility under section 170." *Singer Co. v. United States*, 449 F.2d 413, 423 (Ct. Cl. 1971).

2. A corollary of this rule is that a taxpayer's payment to a charity may be partially tax-deductible where he receives a return benefit that is *not* commensurate with the amount of his transfer. Such a "dual payment" is treated as in part a purchase of goods or services, and in part a charitable contribution. See, e.g., *Goldman v. Commissioner*, 388 F.2d at 480; *Seed v. Commissioner*, 57 T.C. 265, 278 (1971); *Murphy v. Commissioner*, 54 T.C. 249, 254 (1970); *Arceneaux v. Commissioner*, 36 T.C.M. (CCH) 1461, 1464 (1977); Rev. Rul. 68-432, 1968-2 C.B. 104, 105; 2 B. Bittker, *supra*. ¶ 35.1.3, at 35-9. A common example of a "dual payment" is where a taxpayer buys a ticket to a concert held to benefit a symphony orchestra, with the ticket price being set at a level far in excess of the usual price of admission. See Rev. Rul. 67-246, 1967-2 C.B. 104, 107-108.

In order to establish such a "dual payment," the taxpayer must prove that the amount he paid to the charity exceeded the fair market value of the consideration that he received in return. See *Murphy v. Commissioner*, 54 T.C. at 254; *Arceneaux v. Commissioner*, 36 T.C.M. at 1464; Rev. Rul. 67-246, *supra*. For example, if a taxpayer buys a ticket to a benefit dinner or concert, "[t]he test is not the cost of the event to [the charity], but the fair market value of the consideration received by the purchaser of the ticket." Rev. Rul. 67-246, 1967-2 C.B. at 111. The "fair market value" of a product or service is the price at which it would change hands between a willing buyer and a willing seller in the "usual market" in which it is sold. Treas. Reg. § 1.170A-1(c)(2). Thus, if the product is customarily sold at retail, its "fair

market value" is its retail value. *Ibid.*; Rev. Rul. 80-233, 1980-2 C.B. 69; Rev. Rul. 67-246, 1967-2 C.B. at 110. Obviously, the difference between the cost of the *quid pro quo* to the seller and its retail value to the buyer cannot form the basis for an alleged "gift," since that difference is just a designation of the seller's customary profit.

To establish a "dual payment," the taxpayer must also show that he paid the "excess" amount with the intention of making a charitable contribution. See *Murphy v. Commissioner*, 54 T.C. at 254; *Arceneaux v. Commissioner*, 36 T.C.M. at 1464; Rev. Rul. 67-246, *supra*. In many cases, of course, the intent to make a charitable contribution will be evident from the surrounding circumstances. But "the intention to make a gift is \* \* \* highly relevant in overcoming doubt in those cases in which there is a question whether an amount was in fact paid as a purchase price or as a gift" (Rev. Rul. 67-246, 1967-2 C.B. at 105).

#### **B. Respondents Are Not Entitled To A Charitable Contribution Deduction Because They Failed To Prove That They Paid More For The Insurance Than It Was Worth**

1. Consistently with the principles just outlined, the Claims Court correctly held that respondents could not deduct any portion of their insurance premiums as a charitable contribution unless they proved (a) that they had "bought goods or services for more than their economic value" and (b) that they had done so "with the intention that the excess be used to benefit [the Endowment's] charitable enterprise" (Pet. App. 49a). Since the Endowment required all ABA members to waive any claim to policy dividends as a condition of purchasing insurance, the "purchase price" that respondents paid was the gross premium that the Endowment charged. The court found that the Endowment in general set its "gross premiums \* \* \* with reference to the rates for other insurance products available in the market" (*id.*

at 29a (footnote omitted)). Respondents individually testified that they regarded the Endowment's package as "reasonably or competitive[ly] priced" (J.A. 287; see *id.* at 263-264, 269-270). Three of the respondents failed to prove that cheaper insurance was available to them elsewhere during the tax years at issue (Pet. App. 54a-55a). The fourth, while demonstrating that cheaper insurance existed, offered no evidence that he knew about it during those years and had elected, for charitable reasons, to buy the Endowment's policy instead (*id.* at 55a-56a). The Claims Court accordingly held that respondents had failed to carry their burden of proof, since each had failed to demonstrate "that an equivalent insurance product was available to him for a lower price and that he by-passed that product because he wished to make a charitable contribution to the Endowment" (*id.* at 52a (footnote omitted)).

2. In reversing this holding, the court of appeals ruled that the inquiry conducted by the Claims Court—whether respondents could have purchased comparable insurance at a lower price—was "an incorrect definitization of the proper standard" (Pet. App. 19a). The correct legal test, rather, in the court of appeals' view, was "whether the transaction between the Endowment and [respondents] 'was of a business nature and not charitable'" based on "all the pertinent circumstances" (*id.* at 21a). Under that standard, the Federal Circuit said, respondents on remand could "present a *prima facie* case for the deduction \* \* \* simply [by] mak[ing] a sworn assertion that they wanted to aid [the Endowment's] charitable endeavor and entered the Endowment's plan because it enabled them to do so" (*id.* at 22a). The burden of proof, the court said, would then shift to the government to "controvert that position and suggest factors showing that the transaction was basically business-oriented" (*ibid.*).

This reasoning is seriously flawed. As we have shown, the courts of appeals have uniformly held, consistently with congressional intent, that "a payment is not a contribution or gift under section 170 if it is made with the ex-

pectation of receiving a commensurate benefit in return" (*Sedam v. United States*, 518 F.2d at 245). The Federal Circuit completely ignored the economic comparability between what respondents paid for and what they got. Contrary to that court's statement, respondents cannot "present a *prima facie* case for [a charitable] deduction" simply by filing an affidavit averring "that they wanted to aid [the Endowment's] charitable endeavor" (Pet. App. 22a). To the contrary, a taxpayer who seeks to deduct part of an alleged "dual payment" must prove *both* that he paid an amount in excess of the value of any benefit received in exchange *and* that he intended to make a charitable contribution in the amount of such excess. The affidavit contemplated by the court of appeals might be relevant (while surely not dispositive) as to the latter point, but it is absolutely irrelevant as to the former. The question is not simply whether respondents "wanted to aid [the Endowment's] charitable endeavor" (*ibid.*), but whether they bought its insurance with "no expectation of any quid pro quo" (H.R. Rep. 1337, *supra*, at A44).

It has long been established that a taxpayer bears the burden of proving both the fact and the amount of his deductions. See, e.g., *Helvering v. Taylor*, 293 U.S. 507, 514-515 (1935); *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Rockwell v. Commissioner*, 512 F.2d 882, 885 (9th Cir. 1975). In the case of charitable deductions based on alleged "dual payments," the courts have correctly applied this general rule by requiring the taxpayer to prove that his payment to charity exceeded the economic value of any return benefit received. See pages 42-43, *supra*. The court of appeals' proposed procedure, by requiring the government to "controvert" respondents' affidavits and prove "that the transaction was basically business-oriented" (Pet. App. 22a), would in effect shift to the Commissioner the burden of proving the reverse.

3. In the Claims Court, respondents did not contend that they should be relieved of their burden of proving that the gross premiums they paid exceeded the value of



the insurance they acquired. Rather, they contended that they had met this burden, on the theory that the "value" of the insurance they acquired was not its "market value" (Pet. App. 50a), but rather was "the net cost charged by the underwriter," that is, "the gross premium minus the dividend" (*id.* at 52a). This argument was based on the notion that ABA members, by mounting a "grass-roots movement" (*id.* at 41a), could "change the [insurance] arrangement at any time, thereby depriving the Endowment of the dividends" (*id.* at 52a).

Respondents' argument was a restatement of the "group gift" theory that the Endowment proffered in contending that it was not in a "trade or business." As we have shown (see pages 36-39, *supra*), that theory is entirely specious. While erroneously accepting that theory in the Endowment's case, the Claims Court rejected it in the case of the individual respondents, and did so correctly. The court noted that the decision whether to make a charitable contribution, like the decision whether to buy insurance to begin with, "is an individual one" (Pet. App. 53a). Thus, the fact that "the group as a whole could lower insurance rates is of little relevance to an individual member who must decide whether or not to participate in the insurance program as it is in fact structured" (*ibid.* (footnote omitted)). "Under the applicable law," the court held, "[a]n individual inquiry must be conducted" to determine whether a particular member "would buy the insurance regardless of whether [he] intended to make a donation" (*ibid.*).

The Claims Court in this respect was plainly correct. Respondents, like all other ABA members, as individuals have absolutely no choice about whether they will waive their policy dividends. If they will not waive their dividends, they cannot get insurance; it is simply part of the price of admission. The Endowment sets its price of admission fully cognizant of the valuable function it performs by assembling a pool of better-than-average insurance risks and negotiating favorable contracts with its underwriters. That in turn enables the Endowment to

make substantial profits while keeping its retail price competitive. Many lawyers elect to pay that price because they cannot find a better buy elsewhere. The simple fact of the matter is that ABA members, as individuals, do not have access to the wholesale group insurance market, but must pay the retail price, and the Endowment in this respect charges whatever the retail market will bear. Respondents "got just what [they] paid for" (*Goldman*, 388 F.2d at 480)—insurance at market prices—and they accordingly have no claim to any charitable contribution deduction.

### CONCLUSION

The judgment of the court of appeals should be reversed, and the cases should be remanded to that court with instructions to reverse the Claims Court's judgment in the Endowment's case and to affirm the Claims Court's judgment in the cases of the individual respondents.

Respectfully submitted.

CHARLES FRIED  
*Solicitor General*

ROGER M. OLSEN  
*Acting Assistant Attorney General*

ALBERT G. LAUBER, JR.  
*Assistant to the Solicitor General*

GARY R. ALLEN  
ROBERT S. POMERANCE  
*Attorneys*

FEBRUARY 1986



8  
No. 85-599

Supreme Court, U.S.

FILED

MAR 28 1986

JOSEPH F. SPANIOLO, JR.  
CLERK

IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1985

UNITED STATES OF AMERICA,

*Petitioner*

v.

AMERICAN BAR ENDOWMENT,  
FREDERICK D. TURNER *et ux.*,  
ARTHUR M. SHERWOOD *et ux.*,  
FREDERICK G. BOYNTON and  
HERBERT C. BROADFOOT, II *et ux.*,

*Respondents*

On Writ Of Certiorari To The  
United States Court Of Appeals  
For The Federal Circuit

**BRIEF FOR RESPONDENTS**

FRANCIS M. GREGORY, JR.  
(*Counsel of Record*)

RANDOLPH W. THROWER  
MAC ASBILL, JR.  
CAREY P. DEDEYN  
SHEILA J. CARPENTER

SUTHERLAND, ASBILL & BRENNAN  
1666 K Street, N.W.  
Suite 800  
Washington, D.C. 20006  
(202) 872-7800

*Attorneys for Respondents*

RECEIVED  
HAND DELIVERED

MAR 28 1986

OFFICE OF THE CLERK  
SUPREME COURT, U.S.

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

**BEST AVAILABLE COPY**

53175

## QUESTIONS PRESENTED

1. Whether policyholder dividends in a group insurance program that are assigned to the American Bar Endowment by its insured members in a charitable fundraising program constitute income from an unrelated trade or business?

2. Whether the Federal Circuit correctly remanded the cases of the four individual insureds to the Claims Court for a determination of whether a charitable contribution deduction for the assignment of such dividends was appropriate in light of "all the pertinent circumstances" involving the relationship between the four insured members and the Endowment, including the motivation and intent of each individual claiming a charitable deduction?

## TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED .....	i
TABLE OF AUTHORITIES .....	iv
RULE 28.1 STATEMENT .....	1
STATEMENT OF THE CASE .....	2
A. The Facts .....	2
B. Proceedings Below .....	13
SUMMARY OF ARGUMENT .....	15
ARGUMENT .....	21
I. The Policyholder Dividends Assigned To The Endowment By Insured Members Are Derived From A Charitable Fundraising Pro- gram And Are Not "Income" From A Trade Or Business .....	21
A. The Record Below and the Concessions of the Government Require Affirmance .....	21
B. The Federal Circuit Applied the Statutory Standard Correctly .....	24
C. The Claims Court Properly Found That the Dividends Greatly Exceeded the Value of the Endowment's Services .....	26
D. The United States Offers No Basis For Setting Aside the Findings and Judgments of the Courts Below .....	30
1. The Legislative History Supports the Holdings Below .....	30
2. The Trade Association Cases Are Not This Case .....	32
3. The Wholesale-Retail Analogy Is Inap- posite .....	35
4. The Government's Fear of Tax Abuse Is Baseless .....	37

II. The Federal Circuit Was Correct In Holding That Individual Insured Members Should Have The Opportunity Of Proving That They Par- ticipated In The Group Gift By Assigning Their Proportionate Share Of Dividends To The Endowment <sup>†</sup> For Charitable Purposes ....	38
A. Introduction .....	38
B. All Parties Recognize the Dual Payment Concept .....	39
C. The Insured Members Made a Dual Pay- ment .....	40
D. Requiring a Contribution as a Condition of Participating in the Endowment's Plan Does Not Negate Recognition of the Con- tribution .....	42
E. The Federal Circuit's Decision Is Consis- tent With Established Principles of Tax Law .....	43
CONCLUSION .....	46



## TABLE OF AUTHORITIES

Page

## CASES:

<i>Carolinas Farm &amp; Power Equip. Dealers' Ass'n v. United States</i> , 699 F.2d 167 (4th Cir. 1983), <i>rev'g</i> , 541 F. Supp. 86 (E.D.N.C. 1982) ....	32, 33-34
<i>Crosby Valve &amp; Gage Co. v. Commissioner</i> , 380 F.2d 146 (1st Cir.), <i>cert. denied</i> , 389 U.S. 976 (1967) .....	31
<i>Disabled American Veterans v. United States</i> , 650 F.2d 1178 (Ct. Cl. 1981), <i>aff'd</i> , 704 F.2d 1570 (Fed. Cir. 1983) .....	25, 34, 42-43
<i>Enright v. Commissioner</i> , 56 T.C. 1261 (1971) .....	42
<i>Estate of Jordahl v. Commissioner</i> , 65 T.C. 92 (1975) .....	21
<i>Estate of Worster v. Commissioner</i> , 47 T.C.M. (CCH) 1266 (1984) .....	42
<i>Helvering v. Bliss</i> , 293 U.S. 144 (1934) .....	39
<i>Louisiana Credit Union League v. United States</i> , 693 F.2d 525 (5th Cir. 1982), <i>aff'g</i> , 501 F. Supp. 934 (E.D. La. 1980) .....	32, 34
<i>N.W.D. Investment Co. v. Commissioner</i> , 44 T.C.M. (CCH) 1246 (1982) .....	42
<i>Professional Ins. Agents v. Commissioner</i> , 726 F.2d 1097 (6th Cir. 1984), <i>aff'g</i> , 78 T.C. 246 (1982) .....	32-33
<i>Pullman-Standard v. Swint</i> , 456 U.S. 273 (1982) .	18
<i>Rogers v. Lodge</i> , 458 U.S. 613 (1982) .....	18
<i>Sedam v. United States</i> , 518 F.2d 242 (7th Cir. 1975) .....	43-44
<i>Singer Co. v. United States</i> , 449 F.2d 413 (Ct. Cl. 1971) .....	43, 44
<i>Stubbs v. United States</i> , 428 F.2d 885 (9th Cir. 1970), <i>cert. denied</i> , 400 U.S. 1009 (1971) .....	43, 44

## Table of Authorities Continued

Page

## INTERNAL REVENUE CODE AND REGULATIONS:

Section 61 .....	41
Section 170(a) .....	39
Section 170(c) .....	39
Section 501(c)(3) .....	2, 35
Section 501(c)(6) .....	35
Section 501(c)(8) .....	30
Section 501(c)(9) .....	30
Section 501(c)(19) .....	30
Section 512(a)(1) .....	24
Section 512(a)(4) .....	30
Section 513(c) .....	18, 24
Treas. Reg. § 1.61-2(d) .....	41
Treas. Reg. § 1.513-1(b) .....	31
Treas. Reg. § 1.170A-1(c)(2) .....	40

## LEGISLATIVE MATERIALS:

S. Rep. No. 2375, 81st Cong., 2d Sess. (1950) .	31
H. Rep. No. 2319, 81st Cong., 2d Sess. (1950) .	31

## STATE STATUTES:

Ill. Rev. Stat., ch. 73, arts. II and III (1981) ...	27
Ill. Rev. Stat., ch. 73, § 1065.40 (1981) .....	27

## INTERNAL REVENUE SERVICE POSITIONS:

Rev. Rul. 67-246, 1967-2 C.B. 104 .....	43
Rev. Rul. 76-490, 1976-2 C.B. 300 .....	42
Rev. Rul. 84-147, 1984-2 C.B. 201 .....	42
G.C.M. 38955 (June 29, 1982), <i>reprinted in</i> [1982-1983 Transfer Binder] IRS Positions Rep. (CCH) ¶ 1157 .....	21

## Table of Authorities Continued

	Page
COURT RULES:	
Supreme Court Rules	
Rule 28.1 .....	1
Rule 34.1.(g) .....	2
Federal Rule of Civil Procedure 52(a) .....	- 17

IN THE  
**Supreme Court of the United States**  
 OCTOBER TERM, 1985

---

**No. 85-599**

---

UNITED STATES OF AMERICA,

*Petitioner*

v.

AMERICAN BAR ENDOWMENT,  
 FREDERICK D. TURNER *et ux.*,  
 ARTHUR M. SHERWOOD *et ux.*,  
 FREDERICK G. BOYNTON and  
 HERBERT C. BROADFOOT, II *et ux.*,

*Respondents*

---

On Writ Of Certiorari To The  
 United States Court Of Appeals  
 For The Federal Circuit

---

**BRIEF FOR RESPONDENTS**

---

**RULE 28.1 STATEMENT**

Reference is made to the Endowment's Rule 28.1 Statement in its Brief in Opposition. There are no changes in that statement.

## STATEMENT OF THE CASE

The Government did not challenge the factual findings of the Claims Court in the Federal Circuit, and the Federal Circuit specifically affirmed the findings of the Claims Court. (Pet. App. 2a-9a) Yet the Government is in effect asking this Court to reverse Chief Judge Kozinski's findings of fact, entered after a month's trial involving 23 witnesses and hundreds of exhibits. *See* Rule 34.1.(g). Thus, the following statement of facts is essential to an understanding of this case and the issues before the Court.

### A. The Facts

#### The Endowment's Program

The Endowment is a section 501(c)(3) membership organization, the charitable purpose of which is to make grants to fund legal research and education for the advancement of the administration of justice and the science of jurisprudence. (Pet. App. 2a, 26a; JA 72; CA App. 906-13 at 907, JA 124, 125) All members in good standing of the American Bar Association ("ABA") are members of the Endowment ("ABE"). (Pet. App. 2a, 26a; JA 72) In the 1950's, the Endowment, at the suggestion of the ABA, developed a charitable fundraising plan through a group life insurance program for ABE members that was designed to generate sufficient contributions to enable the ABE to further its charitable objectives. (Pet. App. 26a-27a; JA 73-75) As an integral feature of the charitable fundraising plan and as a condition for participating in the program, members agreed on the insurance application to assign their proportionate share of policyholder dividends as contributions to the

Endowment. (Pet. App. 3a, 32a; JA 76, 78, 82, 121-22, 293-94) Each year the Endowment informed its members of "what percentage of the total premiums had been refunded and used for charitable purposes," so that members could, if they chose, claim a charitable contribution deduction. (Pet. App. 33a; JA 82-83, 232-34; CA App. 855-92, 1205)<sup>1</sup>

The insurance offered through the Endowment's program is professional association group insurance—now a common concept, but a new one in 1955. (Pet. App. 35a; JA 156, 159-60) Under such an arrangement the association serves as the group policyholder. One or more insurance companies underwrite the plans of insurance, and there may be a broker or agent of record. The administration of the insurance program is accomplished by the association and/or by a third party administrator or sometimes by the insurance company. (JA 166-67, 211-12) During the years in issue, New York Life and Mutual of Omaha were the insurers for the Endowment's life and accident and health insurance programs, respectively, and the Endowment purchased the policies through a licensed insurance broker (James Group Service, Inc.) which received a negotiated commission from the insurance companies for its services. (Pet. App. 3a-

<sup>1</sup> That amount equalled a member's attributable portion of the dividends received by the Endowment minus the Endowment's cost of administering the insurance program. (JA 83, 90-91; CA App. 893-905, Trial Tr. 1891) Since the Endowment does not have the economies of scale that a professional administrator has, the Endowment's cost of administration exceeds the commercial charge for such services. *See infra*, pp. 26-28. The Endowment's practice of notifying members of the amount of their contributions began in 1964. (JA 234)



4a, 27a) The Endowment administered the programs. (Pet. App. 4a)

Other professional association group plans are designed to provide low cost group insurance as a service to members and have no charitable feature. Policyholder dividends paid by the insurance company normally are returned to participating association members either in the form of a cash distribution or a credit toward future premiums. (Pet. App. 38a, JA 168, 175-76) The Endowment's plan, however, is different from other professional association plans—the dividends on the Endowment's group policies are assigned to it by its members for charitable purposes in the field of law. (Pet. App. 32a-33a, 36a-41a) The program produces an "astounding proportion of its gross premiums recouped as dividends." (Pet. App. 8a)<sup>2</sup>

The dividends are produced by two factors. First, the Endowment's group policies are experience-rated—i.e., the portion of premiums actually retained by the carrier to cover the cost of providing insurance coverage is based on the mortality and morbidity experience of *this group* rather than on a standard actuarial table applicable to the population as a whole. (Pet. App. 29a-31a; JA 326-28, 358-62)<sup>3</sup> The Claims

<sup>2</sup> For example, in the Endowment's fiscal year 1979, 47 percent of the group life insurance premiums were returned to the Endowment as dividends for a total of \$3,466,830. (CA App. 893-96 at 895, Trial Tr. 1891) For the Endowment's fiscal years 1980 and 1981, the life program percentages were 55 percent and 65 percent, respectively. (JA 78)

<sup>3</sup> Such experience-rated policies are not unique to the Endowment. For example, New York Life, a mutual insurance com-

Court found that the 300,000 members of the ABA as a whole have "a very favorable mortality and morbidity rating" which is "a valuable asset" belonging to the group. (Pet. App. 38a; JA 501-02) Second, the gross premiums on the Endowment's insurance program are set intentionally at significantly higher levels than necessary, and "premiums could have been set much, much lower if maximizing participation had been the principal objective." (Pet. App. 28a-29a; JA 158, 160, 182, 190-91, 205, 217-18, 291-92, 341-42, 413)

The Claims Court found that the significant policyholder dividends generated by the interaction of these two factors explicitly reflected the charitable fundraising strategy of ABE *and the wishes and expectations of the ABE membership*. (Pet. App. 35a-41a, JA 505) Participating ABE members knowingly pay premiums much higher than necessary (often twice as much as is necessary) for insurance coverage than they would under a plan without a charitable feature. (Pet. App. 32a-33a, 37a-39a) Instead of pocketing the resulting policyholder dividends themselves as other professionals do, ABE members assign the dividends to the Endowment to be utilized (after the expenses of administering the plan are deducted) for charitable grants in the field of law. (Pet. App. 32a-33a, 36a-40a) The Claims Court found that "the program was devised as a means for fundraising and has

pany, offers experience-rated plans and pays dividends to its other association group policyholders. These policyholders use the dividends for the economic benefit of their members. (JA 175-76, 184-85) Thus, the "net cost" of insurance to members of other professional associations is very low when compared to the Endowment's plan. *See infra*, p. 9 n.5 and p. 11 n.7.

been so presented and perceived from its inception," further stating that the Endowment has "stubbornly adhered to the original concept that its plans are exclusively for fundraising." (Pet. App. 35a-36a; JA 73-75, 123-24, 144-45, 156, 157-58, 291-92)

The ABE insurance program is today and has been at all relevant times an innovative and successful charitable fundraising plan strongly supported by the ABE membership. (Pet. App. 35a-41a; JA 118, 125-26, 146-47, 155-56) From rather modest beginnings in 1955, this charitable fundraising program has expanded over the years to include the participation of tens of thousands of ABE members and has generated tens of millions of dollars in contributions by insured members. (Pet. App. 4a, 27a; JA 72, 93) Those contributions have been the source of grants totaling over \$63 million to such recipients as the American Bar Foundation, the ABA Fund for Public Education, the Institute for Judicial Administration, the Institute for Court Management, the National College of District Attorneys, the National Council of Juvenile and Family Court Judges, the National College of Criminal Defense Lawyers, the National Institute for Trial Advocacy, and the National Legal Aid and Defender Association. (JA 72)<sup>4</sup>

<sup>4</sup> In its fiscal years 1979, 1980 and 1981, the Endowment made grants for a wide variety of projects totaling \$3,602,462, \$4,397,619, and \$4,640,000, respectively. (JA 72) For example, the Endowment's report to its members for fiscal year 1980, published in the ABA Journal, indicates that among the projects fully or partially funded in that year were the publication of the second edition of the American Bar Association Standards of Criminal Justice, a reassessment of state medical practice acts as they pertained to the providers of health care services, an

The Endowment did not function either as an insurer or as a broker. Rejecting the Government's position that the Endowment "sells insurance at fair market retail prices" (Br. 15), the Claims Court found that the Endowment does not buy and sell insurance. It receives no payments from the insurance carriers for services rendered. (Pet. App. 27a, 47a) The Claims Court rejected the Government's contention to the contrary:

All of the evidence on both sides makes it clear that the money here came from premiums, that no matter what the flow of dollars the economic reality was that these were the members paying money to the association and not insurance companies paying the group in some fashion. (JA 508)

The Claims Court also expressly found as a matter of fact that the dividends were not compensation paid to the Endowment, either by the insurance companies or by the insured members. (Pet. App. 27a, 39a-41a; JA 440) Based on all of the evidence at trial, the Claims Court found that—

[t]he amount of money ABE is permitted to retain far exceeds the value of any service it may be providing through the operation of the insurance programs. It is quite obvious,

---

examination of sentencing guidelines to obtain greater uniformity, an ABA project on victim/witness assistance, the ABA Action Commission to Reduce Court Costs and Delays, the minority bar leaders conference, legal assistance to the poor programs sponsored by the National Legal Aid and Defender Association and a training program of the National College of Criminal Defense Lawyers and Public Defenders. (CA App. 984-87, Trial Tr. 1894)



then, that this money was not earned "from the sale of goods or the performance of services," 26 U.S.C. § 513(c) (1976), but for some other reason. *That reason was the intent of the members to support the Endowment's charitable activities.* (Pet. App. 41a) (Emphasis added.)

The Government did not challenge these or other findings of fact in the Federal Circuit. Even so, the Federal Circuit reviewed the evidence of record and confirmed the findings of the Claims Court, remarking that "the Claims Court specifically and permissibly rejected the Government's contention that the dividends represent a payment for the Endowment's services." (Pet. App. 11a)

The Claims Court considered the Government's view before this Court that the Endowment "deals with its members, *in their capacity as customers*, in a business-like manner and at arm's length," treating "its market, in short, much as other profit-maximizing enterprises treat theirs" (Br. 37) and rejected it. That court found that "both the ABE leadership and the insured members considered the insurance program a fundraising activity and treated it as such," noting that even the two ABE members who testified for the Government understood that the insurance program was a charitable fundraising activity. (Pet. App. 36a & n.5; JA 122-27, 143-48, 196-97, 295-96, 393, 448-49, 450-51, 454) Furthermore, the Claims Court explicitly found that ABE members were fully and fairly informed in a variety of ways as to the charitable purposes of the insurance program:

[The Endowment] disclosed the relevant facts to its members at every available opportu-

nity, yet the members (who bore the economic cost of this program) allowed the practice to continue although they collectively had the power to change it.

(Pet. App. 40a; JA 223-34, 324, 344-45, 405, 504-05; CA App. 1196-1204; JA 226-28)

ABA/ABE members could have determined to retain the benefit of their favorable mortality and morbidity experience for themselves.<sup>5</sup> The Court found, however, that ABA/ABE members affirmatively chose not to pursue this course:

If the ABA had chosen to do this, it could have offered its members insurance at premiums lower than any other bar association, perhaps the lowest premiums of any group in the country. *The ABA members, however, have chosen a more generous approach*, allowing the Endowment (rather than the ABA) to operate the insurance program and retain the dividends. (Pet. App. 38a) (Emphasis added.)

In addition to the substantial financial sacrifice of those who actually purchased insurance, Chief Judge

<sup>5</sup> "Most professional associations (including almost all bar associations) operate such programs on a service-oriented basis and secure the most economical group insurance for their members." (Pet. App. 38a. See JA 144-45, 159-60, 316, 326) Specifically, the Court found that such a program could have been operated at the same "net cost" as the Endowment's program: "The money that could have been saved by the members who bought insurance was equal to the dividends refunded minus the Endowment's operating expenses. This amounted to several million dollars a year." (Pet. App. 38a n.5; JA 159, 162-63, 218, 330-31, 363-64)



Kozinski observed that the program was "very costly" to those ABA/ABE members who did not buy insurance but allowed the program to continue as a charitable one, thereby denying themselves the opportunity to participate in a low-cost, service-oriented group insurance program. (Pet. App. 38a) Each ABA/ABE member "made a contribution in an economic sense." (JA 503-05)

The Government urged at trial that ABA/ABE members had "no control over the way the insurance programs are operated because the programs are maintained in their present form by an unresponsive leadership" (Pet. App. 39a) and now (as though it had prevailed on that point) urges that change could be effected only by a "grass roots" movement to "oust the current leadership." (Br. 12, 36-39, 45-46) However, Chief Judge Kozinski specifically found to the contrary, holding that there was "nothing" in the record to suggest that the ABA/ABE leadership was unresponsive to the members; the insurance program was "operated with the approval and consent of the ABA membership." (Pet. App. 38a-39a) The Claims Court also found that the attitude of the ABA/ABE leadership toward the program reflected the views of the membership and that, if the members had wanted to discontinue the charitable feature and either lower insurance rates or retain the dividends for themselves, the leadership would have responded by implementing those wishes:

Plaintiff has demonstrated to the court's satisfaction that there are ample, effective channels within the APA for members to make their views known *and have them implemented.*

(Pet. App. 39a-40a & n.9) (Emphasis added.)<sup>6</sup>

The Claims Court specifically addressed what appears to be the factual predicate for the Government's argument in this Court—that the gross premiums paid by Endowment members "were within the competitive range of the market." (Pet. App. 41a) In disagreeing with the Government's legal argument on this point, Chief Judge Kozinski also noted that the Government had not proved its factual case:

The record does not, in any case, fully support defendant's factual contention. As will be discussed more fully below . . . , it is impossible to isolate a single market for insurance. The cost of insurance depends on a variety of factors, many of them individual to each buyer. Thus, while ABE insurance may have been within the competitive range for some potential buyers it was not for others. (Pet. App. 41a n.10)<sup>7</sup>

<sup>6</sup> Wm. Reece Smith, Jr., a former President of the ABA and of the Endowment, testified at length concerning the governance of the ABA and ABE. (JA 131-40) He and other ABA and ABE leaders noted the lack of dissent within the ABA concerning its support of the Endowment's program. (JA 125-26, 145-48) The Court accepted this testimony. (Pet. App. 38a-39a)

<sup>7</sup> The correctness of this finding is illustrated by reference to the prices charged for participation in the New York State Bar life insurance plan. This was the only plan that the trial court found (after minor adjustments) comparable to the life coverage available through the Endowment from New York Life. (Pet. App. 55a & n.17) The net cost (after dividend credits) of participating in the New York plan is lower than the ABE gross premium payments by approximately the amount of the contributions to charity under the ABE plan. This result was disclosed

The Government did not challenge this finding below; it simply asserts the contrary to this Court.

The Claims Court viewed comparison of rates between group insurance and individual insurance as "inherently misleading" (JA 512), observing that there are many factors that need to be considered in valuing a particular insurance policy. (Pet. App. 50a-52a) The Claims Court also observed (JA 511-12) that the Government's suggestion that insurance was capable of valuation in one market was—

simply not supported by this record. I think it is utter nonsense. I think there are at least 50 markets for insurance, particularly group insurance. I think one ought to take into account the basic and significant differences between group insurance and individual insurance. I think individual insurance by clearly established record is a different product and a significantly different product.

#### The Individual Respondents

The brief testimony of Messrs. Boynton, Broadfoot, Sherwood and Turner in support of a charitable contribution deduction must be read in the context of *all* of the testimony at trial in these consolidated cases concerning the relationship of the Endowment members to the insurance program. Each individual insured knowingly participated in the group insurance program operated by the Endowment to raise funds for its charitable purposes. (Pet. App. 38a-39a, 54a-

by the comparative figures presented by the Government's expert actuary (JA 445-47) and recognized by the Claims Court. (Pet. App. 55a)

56a) When each enrolled, he reviewed Endowment literature explaining that dividends would be assigned to the Endowment and utilized for charitable purposes; he signed a statement agreeing and acknowledging that the dividends would be paid to the Endowment. Each plaintiff received the annual notices which the Endowment mailed to its insured members advising of the percentage of his initial premium for the prior year that was considered to be a charitable contribution to the Endowment. Each testified that his checks to the Endowment for semianual premium payments were written with the knowledge that a substantial portion of the amount paid would be a contribution to the Endowment for its work in the field of law. (JA 82-83, 232-34, 260-63, 271-74, 277-79, 282-84; CA App. 855-92, 1205)

#### B. Proceedings Below

On November 11, 1983, the Claims Court delivered a lengthy oral opinion, deciding the unrelated business income case in favor of the Endowment, concluding on the basis of the facts proved at trial that the insurance plan of the Endowment "is not a business" and that the Endowment "is not making a profit from its enterprise." (JA 498-518) Chief Judge Kozinski declined to decide the charitable contribution question at that time because he had "grave doubts" and "I am not going to be able to resolve them today." (JA 510)

Judge Kozinski decided the charitable contribution issue on December 21, 1983. While he recognized the validity for charitable contribution purposes of a dual payment made to obtain both an economic good and a charitable contribution (JA 522; *see* Pet. App. 49a) and acknowledged that Endowment members should



be entitled to make a showing that they made a charitable contribution (JA 539), the court ruled against the four respondents. (See JA 518-40) Chief Judge Kozinski rejected respondents' effort to infer from the "group gift" a charitable motivation applicable to all insured members and held that a charitable deduction would be available on a case-by-case basis if the member demonstrated a charitable motivation by showing that an equivalent insurance product was available to him for a lower price and that he knowingly bypassed that product in order to make a contribution to the Endowment. (Pet. App. 52a; JA 522)

The two oral opinions were followed by a written opinion directed to all five cases. (Pet. App. 25a-56a)

The Federal Circuit affirmed the conclusion of the Claims Court in the ABE's case, observing that "the Claims Court specifically and permissibly rejected the Government's contention that the dividends represent a payment for the Endowment's services" (Pet. App. 11a) and agreed with the Claims Court's conclusion that the Endowment's insurance program did not meet the statutory definition of a trade or business. The court observed that a charity "should not be subject to taxation merely because its charitable solicitations are successful. This would, however, be the result if we adopted the IRS' reasoning in this case." (Pet. App. 12a)

Turning to the charitable contribution issue, the Federal Circuit declined to approve the uniform rule urged by respondents (Pet. App. 21a n.9) and also rejected the "single-factor test" of charitable motivation designed by the trial court. (Pet. App. 19a-23a) It held that "well established principles of tax law from this circuit and elsewhere require that we

reject the unitary approach of the court below and remand for consideration in accordance with those principles as they should be applied to this unique situation." (Pet. App. 15a) The Federal Circuit observed that the Claims Court test improperly required the taxpayer to "prove a charitable motivation of disinterested generosity," failed to "take into account the fact, that, in other plans, the participants are entitled to their dividends", and was based on a false assumption that "all participants are purely 'economic' persons, acting solely on a careful and detailed comparative investigation of pecuniary results and expectations." (Pet. App. 20a) The court then discussed circumstances which would tend to show whether an insured member was charitably motivated or not, and remanded for further proceedings to consider whether "the transaction between the Endowment and the taxpayers involving the assignment of dividends 'was of a business nature and not charitable.'" (Pet. App. 21a-22a)

## SUMMARY OF ARGUMENT

### The Endowment's Case

All this case is "about" is the decision of the members of a professional association to dedicate millions of dollars to charity that they could keep for themselves without any tax consequences to any person. The Claims Court and the Federal Circuit found that dividends assigned by insured members to the Endowment were received by the Endowment as the consequence of a long-standing charitable fundraising program approved of and controlled by the Endowment's membership. They were not attributable to the



conduct of a trade or business and were not derived from the sale of goods or the performance of services.

The findings upon which the conclusions of the lower courts rest are overwhelming. They include the following:

This is not a business and is not making a profit from its enterprise. (Pet. App. 11a-12a, 41a; JA 498)

This was a charitable fundraising program about which the membership was well informed. (Pet. App. 35a-36a)

This perception has been held by many thousands of people for the better part of three decades. (*Id.* 36a)

It was not operated in a competitive manner. (*Id.* 34a-35a)

The insurance program was operated with the approval and consent of the membership. (*Id.* 38a-39a)

The program was maintained in its present charitable form by leadership responsive to the wishes of the members. (*Id.* 39a)

There are ample, effective channels for members to make their views known and have them implemented. (*Id.* 39a-40a)

The excellent mortality and morbidity rating of the members represented a valuable "group asset" which was generously assigned to charity. (*Id.* 31a, 38a; JA 501, 503, 509)

The ABA/ABE members as a group have permitted the Endowment to collect exorbi-

tant revenues when they could easily deny it any and secure for themselves service-oriented group insurance at much lower cost whenever they so desired. (Pet. App. 42a; JA 503)

The huge sums raised by the Endowment were wholly unrelated to the value of services provided by the Endowment. (Pet. App. 40a)

The members would have been subject to an epidemic of irrationality to have permitted such huge charges in a commercial venture: the far more reasonable explanation is that they supported it because they considered it charitable fundraising. (*Id.* 41a)

It is quite obvious that the Endowment's net revenues were not earned "from the sale of goods or the performance of services" but were due to the generosity of the members (*id.* 38a) and their intent to support the Endowment's charitable activities. (*Id.* 41a)

There was no identifiable business over which the ABE was able to gain an unfair advantage. (*Id.* 48a; JA 507)

Taking these facts together, the ABE's activities were not commercial and therefore not a business. (Pet. App. 40a, 48a)

Rule 52(a) of the Federal Rules of Civil Procedure provides that findings of fact shall not be set aside unless found to be "clearly erroneous," with due regard being given to the trial court's opportunity to assess the credibility of the witnesses. The "clearly

erroneous" standard is not limited to subsidiary facts but applies as well to ultimate facts and findings. *Pullman-Standard v. Swint*, 456 U.S. 273, 287 (1982). The rule has been found especially useful in this Court with respect to cases which, like the present one, involve a lengthy trial record, with numerous witnesses and documentary evidence, that has already been fully reviewed and considered by two lower courts. See *Rogers v. Lodge*, 458 U.S. 613, 622-23 (1982), and cases cited therein. The Claims Court's findings of fact, which were specifically endorsed by the Federal Circuit, are conclusive on the question of whether the Endowment had unrelated business income.

The conclusion of the courts below that the amounts in question here do not constitute unrelated business income is consistent with the purpose of the statute as well as its language. Section 513(c) taxes income received from "any activity which is carried on for the production of income from the sale of goods or the performance of services." It is undisputed that the "primary purpose" in enacting the statute in 1950 was to put the business operations of tax-exempt organizations on an equal footing with those of their taxpaying counterparts. The Claims Court and the Federal Circuit found both that the amounts in question were not received from the conduct of a trade or business and that the Endowment was not in competition with any taxpaying entity.

The Government admits that a professional association group policyholder conducting an insurance program in precisely the manner in which the Endowment has conducted this program is not engaged in a trade or business if it offers to return to insured

members the excess of dividends over expenses. Yet the Government would tax the Endowment, apparently not because of its activities, but because the Endowment restricts its program to members who have agreed in advance to assign their dividends for charitable purposes. The Government's purported distinction relates only to the form of the gift by members and refuses to recognize its reality.

The trade association cases relied upon by the Government are based on findings that the dollars there in question were paid to business leagues by insurance companies *in exchange for* the performance of services. The legal question addressed by those courts—whether earnings from these services did not constitute "business" income because the associations allegedly lacked "profit" motive—does not arise in the Endowment's case because the Claims Court and the Federal Circuit in this case found that the assigned dividends retained by the Endowment were not attributable to the sale of goods or the performance of services.

The Government's contention that the Endowment bought insurance at "wholesale" and sold it at "retail" ignores the findings of the Claims Court. The Claims Court found that the members of the Endowment do *not* pay the Endowment as "profit" twice as much as they need to pay for insurance, specifically declining to find that ABA members are so gullible.

Nor will some tax loophole be opened if the Federal Circuit decision is affirmed. As to the Endowment, the tax consequences are the same as those in other professional association group plans where the associations perform administrative services but return dividends net of expenses to their members; the group



policyholder is not taxed for playing that role. The ABE members who have assigned their dividends to the Endowment for charitable purposes will receive a deduction as would members of other professional associations who decided to dedicate their dividends to charity.

### **The Individual Taxpayers' Cases**

The Government acknowledges the validity of the "dual payment" concept, whereby a single payment to charity may generate a charitable contribution deduction where the transferor intended to make a charitable contribution and received in return a benefit whose fair market value is not commensurate with the amount of the transfer. The Endowment members made a dual payment. Whether one looks at the fair market value of services rendered by the Endowment or the fair market value of the association group insurance received by the members or looks at a combination of both, the insured members have paid grossly excessive amounts for what they have received in return. The members of the Endowment, acting collectively and in a spirit of generosity, denied themselves the low cost insurance coverage enjoyed by other professional associations. The amounts paid to charity add nothing to the fair market value of the economic benefits received by the insured members. An insured member should be entitled to demonstrate his intention to make a contribution. The Federal Circuit, in remanding for further proceedings, applied traditional principles of tax law that do not conflict with any decided cases. The Government in its brief does not identify any issue for this Court to

resolve with respect to the cases of Messrs. Boynton, Broadfoot, Sherwood and Turner.

### **ARGUMENT**

#### **I. The Policyholder Dividends Assigned To The Endowment By Insured Members Are Derived From A Charitable Fundraising Program And Are Not "Income" From A Trade Or Business.**

##### **A. The Record Below and the Concessions of the Government Require Affirmance.**

The Government would tax "policy dividends or retrospective rate credits that accrue to the group policies." (Br. 4) Policy dividends, however, are nothing more than a reduction in the amount of premiums paid. *Estate of Jordahl v. Commissioner*, 65 T.C. 92, 99 (1975). (Br. 4) In recognition that policy dividends are a return of a premium overcharge, as a rule they are not taxed to the recipient. Yet the Government here would tax the policy dividends as gross income to the Endowment, although the Government would not tax the same amounts, either to the Endowment or to the insureds, if the Endowment had engaged in precisely the same activities it did in administering the group insurance program, but had merely offered to return those amounts to insured members upon their request. See G.C.M. 38955 (June 29, 1982), reprinted in [1982-1983 Transfer Binder] IRS Positions Rep. (CCH) ¶ 1157.

In its Brief, the Government concedes that—

[i]f the Endowment had instead consented to rebate the dividends to its members, coupling such rebates with a request that the members voluntarily contribute the dividends back to



it, it would have a strong claim that funds thus contributed were *derived* "from" *charitable solicitations* rather than "from" its insurance business. (Emphasis added.)

(Br. 24-25. *See also* Br. 37.) In offering this concession the Government fails to note that both courts below found that "funds thus contributed" by insured members *in fact* were "derived 'from' charitable solicitations" and were *not* derived by the Endowment "from" an "insurance business."

The Federal Circuit captured precisely the fallacy in the Government's position when tested by the record in this case. The Federal Circuit observed (Pet. App. 12a n.6):

On the conclusion reached below, which we accept, our refusal to view the recouped dividends as payment for the Endowment's services is consistent with the IRS' own memoranda. In G.C.M. 38940 [which concerned the Endowment's case] ... the IRS stated that a group policy holder such as the Endowment "serves as group policyholder *in exchange for which* the individual insured members agree to pay premiums and irrevocably assign their share of the premium refunds." (Emphasis in original.) In G.C.M. 38955 ... the IRS stated that a similar plan did not subject a charitable organization to taxation if it offered to distribute the dividends to those participants who so requested. The IRS concluded that the offer of a rebate negated the presumption that the dividend was consideration for the organization's services. *In the present case, the Claims Court specifically found that the assignment of dividends was not an exchange for services, but rather reflected the intention of the*

*membership to support the Endowment's charitable activities. This case therefore falls within the rule of G.C.M. 38955, rather than G.C.M. 38940.* In any event, we fail to see how one plan competes any less with commercial group insurance plans than the other. If any difference exists, the plan which offers to distribute the dividends presents the greater possibility of competition with taxed organizations. (Emphasis added.)

There is no distinction in principle or, as found by the Claims Court and the Federal Circuit, in fact, between the *continuing decision* of the Endowment members to assign each year's dividend for charitable uses and an *annual decision* to give an attributable portion of that year's dividend to charity, except that the Endowment's plan is wholly charitable and the other is only partially so. The form of the program hardly turns charitable contributions into unrelated business income.<sup>8</sup>

---

<sup>8</sup> As the Claims Court noted (Pet. App. 46a), the Internal Revenue Service on two occasions (1972 and 1973) ruled that the dividends received and retained by the Endowment did *not* constitute unrelated business income. The Court observed:

It is also not without significance that for 21 years the Internal Revenue Service took the position that ABE's operation of the insurance program was not taxable. *See* IRS Letter Ruling 8042012 (July 3, 1980) (citing unpublished technical advice memorandum of January 31, 1973, that concluded ABE's insurance program was not a business). This suggests that whatever UBIT policies the ABE's activities are thought to implicate must be subtle indeed.

**B. The Federal Circuit Applied the Statutory Standard Correctly.**

The Endowment can be taxed only to the extent it realizes "unrelated business taxable income," which in pertinent part is defined by section 512(a)(1) of the Internal Revenue Code of 1954 (as amended) as—

the gross income derived by any organization from any unrelated trade or business (as defined in section 513) . . . less the deductions allowed . . . .

(Pet. App. 63a) A "trade or business" is defined by section 513(c) as "any activity which is carried on for the production of income *from the sale of goods or the performance of services*." (Pet. App. 67a) (Emphasis added.)

The Government asserts that the Endowment's "insurance activities obviously comprise both 'the sale of goods' and the 'performance of services,'" and argues that the dividends were compensation received by the Endowment from the insurance carriers and its insured members for such goods or services. (Br. 23) In doing so, the Government pretends that a trial did not take place and tries to erase from the record the unequivocal findings of both the Claims Court and the Federal Circuit that the dividends received and retained by the Endowment were *not* income from the sale of goods or the performance of services. (See Pet. App. 9a-12a, 35a-41a and *supra*, pp. 7-10, 16-17.)

In addition to applying the plain language of the statute, the Claims Court properly analyzed the Endowment's activities taken as a whole, concluding that the Endowment "is not a business and is not making

a profit from its enterprise." (JA 498; Pet. App. 33a-41a) In testing the Endowment's program against the statutory standard, the Claims Court held that an integrated analysis of the Endowment's program made it "impossible to conclude that the insurance programs were operated by ABE in a competitive, commercial manner." (Pet. App. 40a) See Pet. App. 8a-12a and *Disabled American Veterans v. United States*, 650 F.2d 1178, 1185-87 (Ct. Cl. 1981), *aff'd*, 704 F.2d 1570 (Fed. Cir. 1983).

Taken as a whole, the Claims Court's analysis reveals the following: (1) Endowment members paid far more than necessary for group insurance coverage, including all services related thereto;<sup>9</sup> (2) they knew that they were paying far more than necessary; (3) they intended to pay more than necessary in order to support the charitable purposes of the Endowment; (4) they had the power at any time to pay much less, but chose not to exercise that power; (5) the Endowment program was responsive to their wishes, attributable to their generosity, and represented their choice and intent to dedicate tens of millions of dollars to charity rather than returning them to their own pockets; (6) the Endowment does not compete with anyone, but rather serves as a group policyholder, administering its five group insurance policies only for its own members; (7) the Endowment's expenses exceed the fair market value of its services;

---

<sup>9</sup> The Government does not discuss the fact that profiting on services to members was against the policy and practice of the ABA. Former ABA President Wm. Reece Smith, Jr. testified: "To my knowledge the ABA has never sought to make a profit on any services which it renders on behalf of the membership of the Association." (JA 141)



and (8) the insurance itself is provided by commercial insurance companies which earn a taxable profit, and which pay a taxable commission to the Endowment's broker of record. The Government simply refuses to put these factors together and attempts to avoid the logic of the evidence at trial by treating the Claims Court's findings as if they were unrelated, offhand conclusions. (Br. 31-40)

**C. The Claims Court Properly Found That the Dividends Greatly Exceeded the Value of the Endowment's Services.**

The Endowment performed *only* those services normally performed by a group policyholder either with or without the assistance of a third party administrator. (JA 91-92, 167-68, 200-01, 247-48, 440, 482-83)<sup>10</sup> The Claims Court recognized that these were "insurance-related services." (Pet. App. 27a, 40a)

Against this background, the Claims Court analyzed the Endowment's role with reference to the traditional players in an association group insurance relationship. The Endowment was not an insurer. New York Life and Mutual of Omaha performed that function; they handled medical underwriting, bore the risk that claims would exceed premiums and received their normal compensation for so doing. (Pet. App. 27a, 47a; JA 83, 215-16) The Endowment did not function as an insurance agent or broker. (Pet. App. 27a; JA 83, 87, 212-14) New York Life and Mutual of Omaha paid commissions *only* to the broker of record, James

<sup>10</sup> The Endowment is not unique among association group policyholders in dispensing with the services of a third party administrator. (JA 168, 185, 187, 201)

Group Service, Inc., and not to the Endowment. (JA 170, 212-14, 300-03)<sup>11</sup>

In July of 1981, James Group Service, Inc., a third party administrator which has served as the Endowment's broker, proposed to the Endowment that it perform *all* services performed by the paid staff of the Endowment in connection with the Endowment's insurance programs for an annual fee of \$997,600, in addition to its brokerage commission of approximately \$70,000. (JA 87, 312-13; CA App. 1173-84; JA 310-11) The proposal included a profit to James Group of approximately 25% and specifically reserved an opportunity to bid against any lower proposals, if the Endowment put the administration of the plan out for competitive bids. (JA 311-12)<sup>12</sup> The Government's expert economist conceded that in a competitive bidding situation a competitive bid by a third party administrator would include only a "miniscule profit." (JA 481)

The Government asserts that the Endowment is compensated for "exploit[ing] a very valuable, but vir-

<sup>11</sup> The Endowment could never have been qualified as an insurance company under Illinois law. *See, e.g.*, Ill. Rev. Stat., ch. 73, arts. II and III (1981) (Ill. Insurance Code §§ 6-60). Illinois law would have prohibited any payment to the Endowment for acting as an agent or broker or for organizing and bringing the group to the insurance companies. (Ill. Rev. Stat., ch. 73 § 1065.40 (1981) (Ill. Insurance Code § 493); JA 87)

<sup>12</sup> The James Group offer was not accepted, principally because the Endowment Board did not want to give up the format of a non-commercial program whereby a board of lawyers was responsible to the members for the administration of the program. The Endowment also did not want to become the captive of a third party administrator. (JA 296-97)



tually cost-free asset—a pool of potential insureds, all ABA members, who have far-above-average mortality and morbidity experience.” (Br. 33-34) This is unsupported by the record. Both the insurance plan and the “market” were made available to the ABE by the ABA (JA 73-74, 118-23, 144-45), and cannot be considered a commercial creation of the ABE. The ABA mailing list is available for rent by insurance companies. The uncontradicted testimony is that the American Bar Association, not the ABE, owns the mailing list of ABA members, and that the entire list could have been rented by an insurance company for around \$10,000 in 1981 (and less for prior years). (JA 88, 349-51) In fact, portions of the list were rented by insurance companies during the years in issue. (JA 351-53)

The record thus indisputably shows that the fair market value, including a handsome profit, of *all* services rendered by the Endowment during the years in issue does not exceed approximately \$1,000,000. Nevertheless, the Government contends that the full amount of the dividends returned to the Endowment (ranging from \$5.1 million to \$6.8 million per year during the years in issue (JA 82)) was “compensation” for “services.” The Claims Court found unequivocally that the Endowment received no compensation of any kind from either New York Life or Mutual of Omaha. (JA 508-09) Therefore, the Government must be asserting that the Endowment was paid “compensation” by its insured members of 40.1 to 49.4 percent of gross premiums during the years in issue, an amount that Chief Judge Kozinski found to be grossly in excess of the fair market value of ABE’s insurance-related services. (Pet. App. 40a, 44a)

Not surprisingly, Chief Judge Kozinski rejected the contention that the Endowment members had “been subject to an epidemic of irrationality in permitting themselves to be bilked in this manner for almost three decades” by an organization they control. (Pet. App. 41a)<sup>13</sup> Instead, the Claims Court chose the “far more reasonable explanation” that the members allowed the Endowment to retain this money because they supported its charitable fundraising program. (Pet. App. 33a-41a)

The most strained effort by the Government to avoid the record is on the issue of whether the Endowment realized “profits” and the claim (Br. 33-36) that the “staggering amount of money consistently generated by the Endowment’s activities” (Pet. App. 36a-37a) is in fact indicative of a trade or business rather than the charitable fundraising effort identified by the Claims Court and the Federal Circuit. At trial, the only entities associated with insurance that the Government could point to which in the past had made “profits” equivalent to those it attributes to the Endowment were issuers of credit insurance in loan transactions who had abused consumers and had to be regulated, title insurance organizations which in past years were acknowledged to be “quite abusive”, and certain sponsors of group insurance plans which in past years were characterized as the “robber

<sup>13</sup> Lawyers are hardly a captive market for the Endowment program. Their excellent mortality and morbidity ratings and high incomes make them prime targets for insurers. (JA 188-89) Almost 80% of the Endowment’s members bought their insurance elsewhere. (JA 87) Many insured members, including all four of the individual respondents, utilized the Endowment plan for only a portion of their insurance. (JA 260, 272, 277, 282)

scoundrels" of the insurance industry. (JA 476-78) Chief Judge Kozinski rejected any suggestion that the elected leaders of the Bar, who managed the affairs of the Endowment in response to the wishes of its members, should be placed in the same category as "robber scoundrels." (Pet. App. 37a & n.6; JA 499-500)

**D. The United States Offers No Basis For Setting Aside The Findings and Judgments of the Courts Below.**

**1. The Legislative History Supports the Holdings Below.**

The Government misreads the legislative history of sections 501(c)(8), 501(c)(9), 501(c)(19) and 512(a)(4) expressly exempting from unrelated business income tax the provision by fraternal benefit organizations, voluntary employee benefit associations and veterans' groups, respectively, for the payment of life, sick, accident, or other benefits to members or their dependents. (Br. 19-22) Congress contemplated that either directly providing insurance to members or serving as a commission agent for insurance companies would be related to the exempt purposes of the enumerated organizations. (*Id.* 20-21) The legislative history of these sections of the Code is not relevant here. The Endowment does not contend that its group insurance program is substantially related to its exempt purposes. Moreover, the trial court has found that the excess of its dividends over related expenses is not derived from issuing insurance or providing services to anyone.

It should be noted that the Government's current proposition on the legislative history has never before been advanced in the long administrative and judicial history of this case, not even in 1972 and 1973 when the Service twice ruled in favor of the Endowment

despite the fact that the Congressional actions referred to were fresh. Why did the Government then take seven years to reverse its position, and six more years for this particular argument to surface? The answer is, of course, that the portions of the legislative history now relied upon by the Government have no relevance to the factual setting of this case. The legislative history pertinent to the fraternal, employee and veterans' groups does not indicate a Congressional intent to treat gifts to an organization like the Endowment as unrelated business income.

What is relevant to the Endowment's case is the legislative purpose of eliminating *unfair* competition.<sup>14</sup> The Endowment does not compete unfairly with anyone. It is telling that, despite the enormous amount of discovery conducted by the Government prior to trial, no person testified that the Endowment was competing unfairly with him or her and Chief Judge Kozinski was unable to identify anyone harmed by the Endowment's activities.<sup>15</sup>

<sup>14</sup> The unrelated business income tax was enacted to eliminate *unfair* competition. (Pet. App. 6a n.2; S. Rep. No. 2375, 81st Cong., 2d Sess. 29 (1950)). See also H. Rep. No. 2319, 81st Cong., 2d Sess. 37 (1950); *Crosby Valve & Gage Co. v. Commissioner*, 380 F.2d 146, 148 (1st Cir.), cert. denied, 389 U.S. 976 (1967); Treas. Reg. § 1.513-1(b).

<sup>15</sup> "Now, nobody has really satisfactorily pointed to Ronzoni for me. I have been listening for three weeks of trial and nobody came up and said, 'Here, this is Ronzoni, this is the competitor that is going to be adversely affected in the manner in which Congress feared there would be adverse effects when it slapped Mueller Macaroni Company on the wrist, or basically said you cannot do that, you cannot use your tax exempt status to make profits.'" (JA 507)



## 2. The Trade Association Cases Are Not This Case.

The Government relies heavily on three cases involving trade associations,<sup>16</sup> arguing that those "cases are for all intents and purposes indistinguishable" from the Endowment's case (Br. 28) and ignoring the critical distinctions between those cases and the Endowment's case. The income of the trade associations was received in a commercial context in return for the performance of services, while here the revenues in question were found by the trial court to be derived not from services but from a group gift made by the membership in the context of a charitable fundraising program.

Each of the trade associations was paid a normal commercial fee by an insurance company for services rendered. The associations received percentages of premiums which were "well within the range normally paid for those types of promotional and administrative services, [and] stand in stark contrast to the 40, 50 and even 90% of premiums regularly refunded as dividends and retained by ABE." (Pet. App. 44a-45a)

The principal unrelated business income issue in *Professional Insurance Agents* concerned a percentage of premiums paid to PIA by insurance carriers for its activities in connection with several different group

<sup>16</sup> *Professional Ins. Agents v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984), *aff'd*, 78 T.C. 246 (1982); *Carolinas Farm & Power Equip. Dealers Ass'n v. United States*, 699 F.2d 167 (4th Cir. 1983), *rev'd*, 541 F. Supp. 86 (E.D.N.C. 1982); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982), *aff'd*, 501 F. Supp. 934 (E.D. La. 1980).

insurance programs that it endorsed.<sup>17</sup> It was undisputed that these payments were made by insurance carriers *in return for services rendered to them*. 726 F.2d at 1099, 1100.

In analyzing whether PIA was conducting a trade or business, the Sixth Circuit appropriately focused on the phrase "carried on for the production of income", since it was clear that the fees were derived from the performance of services. The court asked "whether PIA has engaged in extensive activity over a substantial period of time with intent to earn a profit." *Id.* at 1102. Since the record reflected a profit motive, the tax was imposed. In the Endowment's case, on the other hand, the Endowment proved that the monies it received did not come from the sale of goods or the performance of services. Both courts below found that the dollars flowed to the Endowment because the ABE membership wanted dividends to go to charity instead of tax-free to themselves, and not because its activity was carried on to earn a commercial profit from the sale of goods or the performance of services.

<sup>17</sup> The Government claims that the trade associations received and retained dividends from insurance companies. (Br. 26) This statement is misleading. In one case a dividend was returned to the members, as is commonly the case in association group insurance. See *Carolinas Farm & Power Equip. Dealers Ass'n*, *supra*, 541 F. Supp. at 88. The only association that received and retained anything in addition to a flat percentage of premiums was PIA. PIA received an "experience rating reserve" when one of the programs it endorsed was terminated. Although PIA agreed to be responsible for distributing this fund to its members, it never did so and there is no indication that PIA members knew that PIA had received and retained this fund to which they were entitled. 726 F.2d at 1100-01.



The other cases, *Louisiana Credit Union League* and *Carolinas Farm & Power Equip. Dealers Ass'n*, are to the same effect. Normal commercial fees were received from insurance companies in the amount of 2½ percent to 7½ percent in *Louisiana Credit Union League*, *supra*, 501 F. Supp. at 936, and seven percent in *Carolinas Farm & Power Equip. Dealers Ass'n*, *supra*, 541 F. Supp. at 88. Both arose in the same commercial context found in *PIA*. Neither had any of the numerous features of the charitable fundraising program found in the Endowment's case.

The Government seeks to establish the relevance of the trade association cases by asserting that the common objective, here as in those cases, was "to earn a profit." (Br. 23-30) Following this reasoning (that is, to generate "profit" is the same as to generate revenue), it can be said that both General Motors and the United Way seek "to earn a profit." Yet the fundraising of United Way, even though accomplished by a large staff performing many functions, is obviously different from the profitmaking of General Motors. In the broadest sense every charity seeks to maximize the "profits" from its "fundraising";<sup>18</sup> but this does not mean that in every case "profit" indicates the existence of a trade or business or is the

<sup>18</sup> In his opinion, Chief Judge Kozinski used the term "fundraising" to refer to "charitable fundraising" as contrasted with a trade or business. *Cf. Disabled American Veterans v. United States*, *supra*, 650 F.2d at 1182-83 & n.8. The failure of the Government to appreciate this fact perhaps explains why it persists in raising arguments pertaining to destination of income (e.g., Br. 33). The Endowment agrees that the destination of income test is not the statutory standard and has never argued to the contrary.

equivalent of income derived from the sale of goods or the performance of services.<sup>19</sup>

Neither the Claims Court's nor the Federal Circuit's decision stands for the proposition that the differences *per se* between a section 501(c)(3) organization and a section 501(c)(6) organization justify a different treatment for purposes of the unrelated business income tax. If the taxpayers in the cases discussed above had been section 501(c)(3) organizations, the result should have been the same. The difference in treatment in this case is justified by the radical differences in the *programs administered* by the Endowment and the trade associations there involved, not by the difference in the statutory source of the exemption of the organizations administering such programs. The statutory definition of a trade or business should be applied consistently to each exempt organization, and that is precisely what the Claims Court and the Federal Circuit did.

### 3. The Wholesale-Retail Analogy Is Inapposite

In an effort to avoid the Claims Court's finding that the Endowment receives sums "wholly unrelated" to any service it provides, the Government characterizes the Endowment's relationship with its insured members as "buying at wholesale, selling at retail, and rendering the ancillary services necessary to that sales operation." (Br. 25) Of course, the short

<sup>19</sup> The Government's expert economist testified that the maximization of revenue or profits "absolutely" did not provide a basis for distinguishing between charitable fundraising and business profits. Further inquiry was required to determine whether the funds derived were the product of a business or a charitable fundraising effort. (JA 457-58)

answer to the wholesale-retail argument is that the Court found otherwise (Pet. App. 27a, 47a), and Illinois law would not permit the Endowment to sell insurance.

The wholesale-retail argument illustrates the thrust of the Government's case at trial—that the Endowment's insurance program was something other than what it purported to be. It argued that ABE members did not really understand or support the program. It argued that the dividends were payments by New York Life and Mutual of Omaha for bringing the group to the insurance companies. It argued that the Endowment bought insurance wholesale and sold it retail. Rejecting all of these contentions, the Claims Court found that *the Endowment's program in fact was what it purported to be*—a charitable fundraising program in which a group joined together to support projects that they believed to be worthwhile. (JA 500-501) In short, the Government's position has no support in the record.

The Government argues that the Endowment "required members to waive their dividends" (Br. 25) and thereupon set gross premiums at a level competitive with other insurance on the market "so that the *entire amount* the members paid was a *premium payment for insurance*." (*Ibid.* Emphasis in original.) This argument ignores the nature of a dividend. See *supra*, pp. 21-23. It also ignores the fact that, if the Government's wholesale-retail argument were valid, the members of other professional association groups purchased insurance "wholesale." The ABE membership also could have "got it wholesale," but chose not to; the membership decided to assign their dividends to charity.

#### 4. The Government's Fear of Tax Abuse Is Baseless.

Although this charitable insurance program of the ABA/ABE members has been highly visible for 28 years, the record does not reflect a single instance where other professionals have sought to duplicate it. The members of numerous professions have chosen instead to establish service-oriented insurance plans where excess premium dollars were returned to the members tax free. (*E.g.*, JA 144-45, 168, 175-76, 316, 326-27, 381-82, 407-08) ABA/ABE members who participated in the Endowment's insurance program similarly could have chosen to pocket more than \$63 million over the last 25 years (Pet. App. 32a), with no tax liability to themselves. It is hard to suppress skepticism at the Government's unsupported contention that hordes of members of tax-exempt organizations are now prepared to follow the practice of the members of the Endowment and remove from their pockets tens of millions of dollars they have historically kept in order to donate that money for charitable uses. But if the members of these other organizations should decide to dedicate to charitable uses in their respective fields monies that have been going into their own pockets, this should be welcomed, not deplored.

No "loophole" is created by a charitable fundraising program reflecting the wishes and generosity of members, undertaken at a substantial out-of-pocket cost to them. A business group or tax-exempt organization could develop a plan under which a payment is made to secure an economic benefit and in addition make a substantial contribution to charity. See *infra*, Part II.B. There is nothing novel in the concept. Charity dinners, concerts and dances have long been recog-



nized as valid means of charitable fundraising. The Endowment's plan merely applies this concept under the unique circumstances of professional association group insurance.

**II. The Federal Circuit Was Correct In Holding That Individual Insured Members Should Have The Opportunity Of Proving That They Participated In The Group Gift By Assigning Their Proportionate Share Of Dividends To The Endowment For Charitable Purposes.**

**A. Introduction**

The individual taxpayers asked the Claims Court to hold that all insured members of the Endowment were entitled to a charitable contribution deduction on the ground that they knowingly participated in a program in which premiums paid for insurance coverage were intended by the members to be a "dual payment," part for insurance protection and part for charity. The Claims Court declined to so hold, instead concluding that a deduction would be available only if the individual insured could show charitable motivation by proving that an equivalent insurance product was available to him for a lower price and he bypassed that product in order to make a contribution to the Endowment. (Pet. App. 52a; JA 522)

Although the Federal Circuit likewise declined to accept the uniform rule, it nevertheless rejected "the [lower] court's particular method of determining charitable motive" by adopting a "unitary approach". (Pet. App. 15a)<sup>20</sup> The Federal Circuit held that "[t]his de-

<sup>20</sup> Among the deficiencies of the trial court's test is that under it those with the greatest charitable motivation to participate in the Endowment's program would be the least likely to have

termination [of charitable motive and intent] must flow from an examination of all the pertinent circumstances surrounding the individual transaction—there is no single-factor test." (Pet. App. 15a, 21a) Consequently, it remanded for "such further proceedings as are appropriate to determine whether the relationship between the Endowment and the taxpayers was predominantly of a business nature or whether the transaction did have a substantial charitable component." (Pet. App. 22a-23a)

**B. All Parties Recognize the Dual Payment Concept.**

A taxpayer is entitled to a deduction for "any charitable contribution," defined simply as a "contribution or gift" made during the taxable year to or for the use of a qualifying organization. I.R.C. § 170(a) and (c). The deductibility of charitable contributions is a liberalization of the law in the taxpayer's favor, "begotten from motives of public policy, and [is] not to be narrowly construed." *Helvering v. Bliss*, 293 U.S. 144, 151 (1934). It is true that a transfer to a charity is not a contribution if the transferor receives, or expects to receive, *commensurate* economic benefits in return (Br. 40-42), just as it is true that, as a "corollary of this rule" (Br. 42), a taxpayer's payment to a charity may be tax deductible where he receives in return a benefit that is *not commensurate* with the amount of his transfer.<sup>21</sup> In order to establish a dual payment, "the taxpayer must prove that the amount

done the difficult comparison shopping required by the test. Judge Kozinski himself recognized the difficulties of his approach. (JA 522)

<sup>21</sup> As the Government puts it, "[s]uch a 'dual payment' is treated as in part a purchase of goods or services, and in part a charitable contribution." (*Ibid.*)



he paid to the charity exceeded the fair market value of the consideration that he received in return" (Br. 42), and that this excess amount was paid "with the intention of making a charitable contribution." (Br. 43)

In the instant case, each insured member's premium payment to the Endowment was a dual payment in that it was "quite clear that the payments that [the insured members] actually made were, in fact, partially used to buy insurance, and partially by way of the dividends then used to support the charitable purposes of the Endowment." (JA 533) The Federal Circuit remanded only to inquire into whether the member was motivated in part by charitable instincts in making his payments. (Pet. App. 21a-23a)

#### C. The Insured Members Made a Dual Payment.

The Government asserts that the insured members received insurance coverage worth the initial premium paid by each member. However, fair market value "is the price at which [this insurance] would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of the relevant facts." Treas. Reg. § 1.170A-1(c)(2). As the Government concedes, fair market value is determined "in the 'usual market' in which it is sold." (Br. 42) In other words, *the fair market value is measured objectively by the market price for professional association group insurance which the group would have paid absent the charitable program.*

There can be no question about the fair market value of the association group insurance coverage. New York Life and Mutual of Omaha would have

welcomed the opportunity to write the Endowment's plans in the same way as other professional association plans—with the dividends used for the economic benefit of the members. (JA 160 ("Quite eagerly."); JA 218 ("Yes, we would do that.")) If reasoned concepts of valuation are applied—what the insurance would cost without the charitable feature—the answer is that the fair market value of the insurance received by the members is precisely what the *insurance component* of the dual payment cost the insured members. Thus, while the value of services rendered by the Endowment is the only proper measure of the *quid pro quo* received by ABE members from the Endowment, one arrives at the same place if the group insurance is treated as the *quid pro quo*.

The Government, turning away from the most direct evidence of the cost to lawyers of similar coverage (the New York Bar plan discussed *supra*, pp. 11-12 n.7),<sup>22</sup> seeks to value participation in the ABE group insurance plan by reference to what it would have cost the insureds to secure a comparable amount of insurance under a wide range of individual policies or other plans. The Government has failed to recognize that, for tax purposes, the fair market value of participation in a group insurance program is *never* determined by reference to what it would have cost each insured to leave the group and buy other insurance, whether individually or through another group. See I.R.C. § 61 and Treas. Reg. § 1.61-2(d) (the fair market value of an interest in a group term

<sup>22</sup> Even though the New York Bar offers a very inexpensive group life insurance plan, the largest enrollment of any state in the Endowment's much more costly plan was in New York. (JA 183)

policy is determined by reference to the employer's allocable cost of the policy, i.e., what the employer actually paid for it). See also Rev. Rul. 76-490, 1976-2 C.B. 300.<sup>23</sup> This rule of valuation certainly should be followed for a voluntary membership group where the members are fully advised about the program and control it.

**D. Requiring a Contribution as a Condition of Participating in the Endowment's Plan Does Not Negate Recognition of the Contribution.**

The Government rests its case on both the unrelated business income and charitable contribution issues on the ground that the Endowment does not each year offer its members the option of receiving their share of the dividends. (Br. 25, 37) However, the Internal Revenue Service has long recognized that the requirement of a charitable contribution as a condition to obtaining some goods or services does not negate recognition of the charitable contribution to the extent the payment exceeds the value of the goods or services obtained. This concept was expressly recognized by the United States Court of Claims in *DAV*, *supra*. There, both parties agreed that in computing any unrelated business income, the gross income should be based on the fair market value of the pre-

<sup>23</sup> In Rev. Rul. 84-147, 1984-2 C.B. 201, the Internal Revenue Service held that an employee may value a gift arising from the assignment of a group term life insurance policy by reference to "the actual cost allocable to the employee's insurance by obtaining the necessary information from the employer." The Government should simply apply Rev. Rul. 84-147. See generally, *Enright v. Commissioner*, 56 T.C. 1261 (1971); *Estate of Worster v. Commissioner*, 47 T.C.M. (CCH) 1266 (1984); *N.W.D. Investment Co. v. Commissioner*, 44 T.C.M. (CCH) 1246 (1982); Rev. Rul. 76-490, 1976-2 C.B. 300.

miums (i.e., goods) received, "and not on the contribution level which DAV set as a requirement to obtain the premium." 650 F.2d at 1190. (Emphasis added.) Likewise, there is no suggestion in Rev. Rul. 67-246, 1967-2 C.B. 104, that the deduction should be disallowed where the "donor" at a charitable event would gladly have paid the full amount charged for the opportunity provided to socialize with a prospective customer, to be seen with a particular social group, or to hear the only performance being given in the city by the taxpayer's favorite pianist. Indeed, requiring a contribution is the essence of the success of a variety of fundraising events. The knowledge that each participant is paying something extra to eat rubber chicken or listen to a concert encourages others to give. The logical result of the Government's argument is that the premium paid for the charity performance is unrelated business income if the extra payment is not optional. Such a result would deal a stinging blow to charities that depend on fundraising events for their support.

**E. The Federal Circuit's Decision Is Consistent With Established Principles of Tax Law.**

The Government also appears to claim that the individual insureds' cases are in conflict with *Sedam v. United States*, 518 F.2d 242 (7th Cir. 1975); *Stubbs v. United States*, 428 F.2d 885 (9th Cir. 1970), *cert. denied*, 400 U.S. 1009 (1971); and *Singer Co. v. United States*, 449 F.2d 413 (Ct. Cl. 1971). A proper analysis of these cases, however, shows that the Federal Circuit's decision is consistent with each.

In *Sedam*, the taxpayer claimed a charitable deduction for payments made "in consideration" for a nursing home admitting his mother as a resident. 518



F.2d at 245. The court stated that "a payment is not a contribution or gift under section 170 if it is made with the expectation of receiving a *commensurate* benefit in return . . . ." *Id.* (Emphasis added.) There was no contention by the taxpayer that a dual payment was made. He had deducted the entire payment. The Federal Circuit applied the same standard in this case (Pet. App. 13a-15a) as the Seventh Circuit did in *Sedam*. The differing facts dictated different outcomes.

The suggestion that *Singer Co.* conflicts with the Federal Circuit's opinion is somewhat surprising in view of the fact that the Federal Circuit *relied* upon *Singer*. (Pet. App. 15a-18a) In *Singer*, the taxpayer expected that sales of sewing machines to schools at less than market prices would increase future retail sales. A deduction was denied because the taxpayer failed to show that the fair market value of the anticipated economic benefit was less than the discount given to the schools. 449 F.2d at 420, 423-24.

*Stubbs* was a jury case in which the question was whether a landowner could deduct as a charitable contribution the value of land dedicated as a public road. The issue of a *quid pro quo* was put to the jury, which apparently believed the prior inconsistent testimony of the taxpayer at a hearing before the Zoning Commission that he would receive an offsetting economic benefit to an adjacent property by reason of the transfer. 428 F.2d at 887 n.1. As in *Sedam*, there was no contention that there was a dual payment.

Finally, the Government erroneously argues (Br. 45) that the Federal Circuit decision has in some way altered traditional principles of burden of proof applicable in tax refund cases by stating that that bur-

den would shift to the Government on the deductibility issue upon presentation of a *prima facie* case. In fact, the Federal Circuit applied well-recognized concepts of shifting evidentiary responsibilities at trial to the particular circumstances of this case. It outlined those elements which for certain members, taking all facts into consideration, would constitute a *prima facie* case for sustaining the charitable contribution deduction, while outlining other elements as to which a "trial court might reasonably conclude" that "the taxpayer should be denied a deduction." (Pet. App. 21a-22a) A *prima facie* case, of course, is that minimum quantum and quality of proof which, if unrebutted, would entitle the proponent to a judgment on his claim. Once the taxpayer has presented a *prima facie* case, it is only the burden of going forward with additional evidence to rebut that case which shifts to the Government. If the Government discharges its responsibility of coming forward with rebuttal proof, the taxpayer is still required to establish by a preponderance of the evidence his entitlement to the claimed deduction. This process is all that the Federal Circuit decision envisions, and nothing in its opinion offends any notion regarding the burden of persuasion in tax or other civil cases.



CONCLUSION

The judgment of the Federal Circuit should be affirmed.

Respectfully submitted,

/s/ Francis M. Gregory, Jr.

FRANCIS M. GREGORY, JR.

*(Counsel of Record)*

RANDOLPH W. THROWER

MAC ASBILL, JR.

CAREY P. DEDEYN

SHEILA J. CARPENTER

SUTHERLAND, ASBILL & BRENNAN

1666 K Street, N.W.

Suite 800

Washington, D.C. 20006

(202) 872-7800

*Attorneys for Respondents*

March 28, 1986

9  
No. 85-599

Supreme Court, U.S.

FILED

APR 21 1986

JOSEPH F. SPANIOL, JR.  
CLERK

---

**In the Supreme Court of the United States**

OCTOBER TERM, 1985

---

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT, ET AL.

---

ON WRIT OF CERTIORARI TO  
THE UNITED STATES COURT OF APPEALS  
FOR THE FEDERAL CIRCUIT

---

REPLY BRIEF FOR THE UNITED STATES

---

CHARLES FRIED  
*Solicitor General*  
*Department of Justice*  
*Washington, D.C. 20530*  
*(202) 633-2217*

## TABLE OF AUTHORITIES

Cases:	Page
<i>Carolinas Farm &amp; Power Equipment Dealers v. United States</i> , 699 F.2d 167 .....	2
<i>Louisiana Credit Union League v. United States</i> , 693 F.2d 525 .....	2, 5-6
<i>New York State Ass'n of Real Estate Boards Group Insurance Fund v. Commissioner</i> , 54 T.C. 1325 .....	5
<i>Professional Insurance Agents v. Commissioner</i> , 78 T.C. 246, aff'd, 726 F.2d 1097 .....	2, 12
Statute and rules:	
Internal Revenue Code of 1954 (26 U.S.C.):	
§ 501(c)(3) .....	2
§ 501(c)(6) .....	2
§ 513(c) .....	1, 3, 6, 12
G.C.M. 38955 (June 29, 1982), reprinted in [1982-1983 Transfer Binder] IRS Positions Rep. (CCH) ¶ 1157 ....	5
Rev. Rul. 64-258, 1964-2 C.B. 134 .....	5
Miscellaneous:	
H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt.1 (1969) .....	2, 13
S. Rep. 91-552, 91st Cong., 1st Sess. (1969) .....	2, 13



**In the Supreme Court of the United States**

OCTOBER TERM, 1985

---

No. 85-599

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT, ET AL.

---

*ON WRIT OF CERTIORARI TO  
THE UNITED STATES COURT OF APPEALS  
FOR THE FEDERAL CIRCUIT*

---

**REPLY BRIEF FOR THE UNITED STATES**

---

The fact that respondents' brief and ours have something of a ships-passing-in-the-night quality reflects respondents' litigation strategy, which, in this Court as in the courts below, has basically been one of confession and avoidance. Respondents have accepted virtually every contention of a legal nature that we have made. They agree (Br. 24) that this case is governed by Section 513(c) of the Code,<sup>1</sup> which defines a "trade or business" as "any activity which is carried on for the production of income from the sale of goods or the performance of services." They acknowledge (Br. 30-31) that Congress, in legislative history contemporaneous with the enactment of Section 513(c), specifically discussed the group insurance activities of several categories of tax-exempt organizations—fraternal beneficiary societies and voluntary employees' bene-

---

<sup>1</sup> Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the periods at issue (the Code or I.R.C.).

ficiary associations—and referred to those activities as a “business.” S. Rep. 91-552, 91st Cong., 1st Sess. 68 (1969); H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1 at 47 (1969). See U.S. Br. 19-22. Although respondents say that this legislative history “is not relevant here” (Br. 30), they make no effort to explain it away or to show that the Endowment’s group insurance activities differ in any functional respect from the activities to which Congress referred. Respondents acknowledge that three courts of appeals<sup>2</sup> have held that the group insurance activities of another category of tax-exempt organization—business leagues—are a “trade or business,” and they seem to agree (*id.* at 32-35) that those cases are correct in both reasoning and result. See U.S. Br. 25-28. Respondents acknowledge (Br. 35) that those cases cannot be distinguished from this one on the ground principally adduced by the courts below—that the associations marketing insurance there were exempt under Section 501(c)(6), whereas the Endowment is exempt under Section 501(c)(3)—and they appear to acknowledge that the Endowment performs essentially the same insurance services, and markets essentially the same insurance products, that those business leagues did. Finally, respondents seem to agree (Br. 34-35) that the Endowment’s insurance operation entails “extensive activity over a substantial period of time with intent to earn a profit”—a fact which would mean, under the reasoning of the Fourth, Fifth, and Sixth Circuits, that the Endowment’s insurance operation is a “trade or business.” See *Louisiana Credit Union League*, 693 F.2d at 532; *Professional Insurance Agents*, 726 F.2d at 1102.

<sup>2</sup> See *Carolinas Farm & Power Equipment Dealers v. United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *Professional Insurance Agents v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984).

Having agreed with us on the law, respondents place their case squarely on what they call the Claims Court’s “findings of fact” (Br. 18). According to respondents, the Claims Court found as a fact that the Endowment “‘is not a business and is not making a profit from its enterprise’ ” (*id.* at 16, 24-25 (quoting J.A. 498)). This finding was assertedly based on subsidiary factual findings that the Endowment’s insurance revenues are not derived “from” its sale of insurance products or “from” its performance of insurance services (I.R.C. § 513(c)), but rather are derived “from” charitable fundraising, reflecting “the generosity of the [Endowment’s] members and their intent to support [its] charitable activities” (Br. 17). The Endowment asserts that these “findings of fact,” having been deemed “not clearly erroneous” by the Federal Circuit, “are conclusive on the question of whether [it] had unrelated business income” (*id.* at 18), so that there is really nothing for this Court to do but affirm under the two-court rule.

This is essentially the same argument that respondents made in unsuccessfully opposing certiorari. See Br. in Opp. 3-7, 10-16. As we have shown (Reply Br. 7-9, U.S. Br. 32-39), the “findings of fact” on which respondents place such reliance either are not findings of fact at all, or, if they are findings of fact, are irrelevant as a matter of law in deciding the questions presented. We have little to add to what we have already said on that score.

At the end of the day, it seems to us that the outcome of these cases really depends on the answers to two questions. The first is: “Does it make any difference that the Endowment exacts a waiver of policy dividends from its insureds as part of the purchase price of its insurance, instead of soliciting a voluntary charitable contribution from those individuals in the same amount?” The second question is: “Did respondents meet their burden of proving that the price the Endowment charged for its insurance exceeded the fair market retail value of the insurance that its mem-

bers acquired?" We think that the answer to the first question is "Yes" and that the answer to the second question is "No." In the pages that follow, we explain our answers to these two questions, then reply to a few other points.

1. In our opening brief (at 24-25), we suggested that if the Endowment had consented to refund policy dividends to its members, coupling the rebate with a request that the members voluntarily donate the dividends back to it, it would have a strong claim that any funds thus contributed came "from" charitable solicitations rather than "from" its marketing of insurance. The Endowment treats this suggestion as tantamount to a concession that its insurance revenues are nontaxable (Br. 21-23). Policy dividends, the Endowment points out, "are nothing more than a reduction in the amount of premiums paid," so that "as a rule they are not taxed" to the premium-payor (*id.* at 21). The Endowment accordingly professes astonishment that "the Government here would tax the policy dividends as gross income" in its hands, for it sees "no distinction in principle" between its actual *modus operandi* and the one that we hypothesized. In respondent's view, the difference between a program in which members have a choice about getting their dividends back, and one in which they do not, is purely a matter of "form" (*id.* at 23).

We could not disagree more strongly. The difference in our view is both substantial and dispositive. And the difference is equally pronounced at the organizational and at the membership levels.

Policy dividends, as respondent notes (Br. 21), reflect the excess of the gross premiums that an insured pays over the portion that the underwriter retains to cover its claims settlement costs, administrative expenses, and profit. When such dividends are distributed to the insured who paid the premium, they function as a retroactive reduction of his cost, and, unless he has previously claimed a tax deduction for his cost, the dividends do not ordinarily

represent taxable income to him. Nor do such dividends represent taxable income to a group policyholder that receives them from the insurance company, holds them temporarily if at all, and then passes them through to the individual insureds who paid the premiums for the group coverage. In that situation, the association holding the group policy acts as "a mere conduit between the member participants and the insurance company." *New York State Ass'n of Real Estate Boards Group Insurance Fund v. Commissioner*, 54 T.C. 1325, 1335 (1970). Because the group policyholder functions in that situation essentially in an agency capacity, it is not taxed on the dividends passed through to the insureds. Rev. Rul. 64-258, 1964-2 C.B. 134; G.C.M. 38955 (June 29, 1982), *reprinted in* [1982-1983 Transfer Binder] IRS Positions Rep. (CCH) ¶ 1157. See Resp. Br. 21.

The situation is altogether different when the group policyholder refuses to refund the dividends to the premium-payers, but instead insists that they waive the dividends as an absolute condition of buying the insurance. In that event, obviously, the association cannot exclude the dividends from its income on the theory that it is acting as a "conduit" between the underwriter and its members. Equally obviously, the association cannot exclude the dividends from its income on the theory that they represent a retroactive reduction of its premium cost, since it did not pay the premiums to begin with. Under these circumstances, the conclusion is inescapable that the insurance revenues retained by the association, contrary to respondent's contention, represent income in its hands.

In *Louisiana Credit Union League*, a decision whose reasoning and result respondents profess to accept (Br. 32-35), the Fifth Circuit considered and rejected the very argument that the Endowment makes here. The business league that served as group policyholder in that case noted that its revenues took the form of "premium rebates" from



the underwriters, and it “invoke[d] the established principle that mutual insurance premium rebates are not income to the policyholder” (693 F.2d at 531). The court found that principle “inapposite to the case at bar” (*ibid.*). The association, the Fifth Circuit observed, did not “act as a conduit between insured and insurer,” since, after receiving payments from the underwriter, it “ma[de] no corresponding distribution to the individual \* \* \* policyholders” (*ibid.*). The court accordingly held that “the insurance-related payments received by the [association] must be considered income in its hands,” income that represented the fruit of its considerable promotional, marketing, and administrative efforts (*ibid.*).

The Fifth Circuit’s reasoning, which is equally applicable here, surely comports with common sense. If the Endowment had refunded the dividends to its members, and the members had voluntarily donated the money back to it, it would have a good argument that the money came to it in the form of charitable contributions, that is, from a source *wholly independent* of its insurance operation. As it is, all the money that the Endowment receives comes to it in the form of insurance-related payments—either as premiums from its members or as policy dividends from its underwriters—so that its revenues necessarily constitute income “from” the insurance-related products that it sells and “from” the insurance-related services that it performs (I.R.C. § 513(c)).<sup>3</sup>

<sup>3</sup> The Endowment argues that it does not “sell insurance” (Br. 7) and that Illinois law forbids it to earn commissions as an insurance “agent or broker” (*id.* at 27 n.11). This is a quibble. What respondent “sells” is participation in group insurance plans that it contracts with insurance wholesalers to underwrite. As the Claims Court found (Pet. App. 26a), respondent’s program is “based upon the sale of group life insurance.” The business leagues in the Fourth, Fifth, and Sixth Circuit cases, whose reasoning respondent purports to accept (Br. 32-35), “sold” precisely the same commodity. Respondent is as much engaged in “sales” as any real estate agent, jobber, or other middleman who brings buyers and sellers together.

The distinction between the Endowment’s program and one in which members are entitled to get their dividends back is equally apparent from the insureds’ point of view. The Endowment’s members who balked at waiving their dividends, but who found that they “either agreed to that or didn’t get the insurance” (J.A. 448, C.A. App. 1276, 1277), unquestionably saw the distinction. The insured who struck the dividend waiver clause from his application form, only to be told that he could not get insurance without accepting the same terms as everybody else (J.A. 293-295, C.A. App. 1135), unquestionably saw the distinction. Even the individual respondents, who testified to their awareness of the charitable uses to which their funds would be put, stopped short of testifying that, given the option, they would have elected to assign their dividends to the Endowment. See U.S. Br. 6-7. To put it bluntly, the alternative *modus operandi* that we hypothesized would provide an acid test of charitable intent. The Endowment’s brief speaks often of its members’ “spirit of generosity” (Br. 20) and of their unswerving “intent to support [its] charitable activities” (*id.* at 17). But the inescapable fact is that the Endowment requires them to waive their dividends.

2. This brings us to what we think is the second key question in the case, which concerns the “value” of the insurance that the Endowment offers for sale. At this point, the Endowment’s argument and that of the individual respondents merge. The Endowment argues that its insurance activities really resemble “[c]harity dinners [or] concerts” (Resp. Br. 37-38, 42-43). As we have noted (U.S. Br. 42-43), a payment to a charity in certain circumstances may be treated as a “dual payment,” that is, as in part a purchase of goods and services and in part a charitable contribution. A common example of a “dual payment” is where a taxpayer buys a ticket to a concert or dinner held to benefit a charity, the ticket price being set at a level far

in excess of the usual price of admission, or of the retail value of the meal. As respondents note (Br. 37-38), the fact that attendees at these functions have no choice about paying an "excessive" price—they must pay the full freight or not go—does not normally defeat a charitable-contribution deduction in the amount of the "excess." The fact that ABA members have no choice about waiving their dividends, respondents argue, should similarly make no difference in determining whether (1) the Endowment is in a "trade or business" or (2) the members are entitled to a tax deduction.

The factual premise of this "dual payment" argument is that the price the Endowment charges for participation in its group insurance plans vastly exceeds the fair market retail value of the coverage that its members acquire. To investigate that premise—a premise as to which respondents, as they concede (Br. 39-40), had the burden of proof—a trial was necessary. The evidence at trial showed that the Endowment advertised its premium charges as "reasonable," "attractive," "affordable," "economic," or "modest" (J.A. 239-240, 241; C.A. App. 988-1012, 1226-1268). It did so because it knew that its members were looking for "a good deal, and a good buy" (Br. in Opp. B12). The Endowment constantly monitored and adjusted its gross premium levels to keep them within the competitive range (Pet. App. 3a-4a, 28a-29a; J.A. 127-128; C.A. App. 1279, 1282). The evidence showed that the Endowment's prices, comparatively speaking, more than held their own in the retail market generally. In 1978, the Endowment conducted a study that compared its premium rates with the prices charged for group life insurance offered by state and local bar associations and similar groups (C.A. App. 1378-1384). The study showed that, of the 29 state bar plans considered, twenty cost *more* than the Endowment's, only four cost less, while five

were adjudged not suitable for comparison (*ibid.*).<sup>4</sup> The Endowment thereafter detected some slippage in its standing, and in 1980, on the recommendation of the underwriter, it lowered the rates for its life insurance so as to "make the life plans competitive in today's market" (J.A. 169, 191-192; C.A. App. 1074-1080, 1119). The Endowment concurrently reviewed its rates for hospital and disability coverage, concluding that "[t]he present premium \* \* \* is competitive in the marketplace" (C.A. App. 1120, 1121).

The individual respondents testified that they regarded the Endowment's gross premiums as "reasonably or competitive[ly] priced," although not necessarily the cheapest on the market (J.A. 263-264, 269-270, 287). One of the individual respondents and one nonparty insured testified that they had previously held group insurance through their state bar associations, but had discontinued that coverage because it cost more than the Endowment's (J.A. 265-267, 389-392, 393, 511-512). None of the individual respondents testified that he chose the Endowment's coverage over a cheaper policy in order to further the Endowment's educational goals. None testified that he thought the gross premiums charged by the Endowment exceeded the economic value of the insurance that he purchased.

Reviewing all this evidence, the Claims Court concluded that it was impossible to isolate a single national market for insurance (Pet. App. 51a-52a), and that, in view of geographical and risk factors unique to each insured, insurance was a difficult commodity to value (*id.* at 29a n.4,

<sup>4</sup> This evidence points up the error of respondent's assertion (Br. 4-5 n.3) that "the 'net cost' of insurance to members of other professional associations is very low when compared to the Endowment's plan."

50a-51a & n.12).<sup>5</sup> In general, however, the court found that the Endowment's "gross premiums were set with reference to the rates for other insurance products available in the market" (Pet. App. 29a (footnote omitted)). It found that the "Endowment staff reviewed other insurance products available to ABE members and compared them to those offered by the Endowment. Where appropriate, adjustments were made to keep the cost of ABE insurance more or less competitive" (*ibid.*). The court found that the Endowment's "advertising [was] aggressive, and in some ways suggested that [its insurance] may be the best deal in the market, and indeed, for many people, from the best [the court could] tell, across the country it may very well have been a very good deal, and perhaps the best deal" (Br. in Opp. B13). As to the four individual respondents, the court concluded that each had failed to prove "that an equivalent insurance product was available to him for a lower price and that he by-passed that product because he wished to make a charitable contribution to the Endowment" (Pet. App. 52a (footnote omitted)). And the Federal Circuit, while disagreeing with the Claims Court's disposition of the charitable-contribution issue as a legal matter, accepted both its particular findings about the individual respondents and its

<sup>5</sup> Respondents make much of the Claims Court's findings in this respect. See Resp. Br. 11-12. Respondents, however, had the burden of proving that the Endowment's prices exceeded the generally-prevailing market range; to the extent that this task was complicated by the inherent difficulty of valuing insurance, their case was the weaker, not the stronger, for it. And while the Endowment's prices were surely more attractive to some ABA members than to others (see *id.* at 11), this case involves the taxability of the dividends generated by the 20% who actually bought the insurance. Members who found the Endowment's prices attractive—either because they did comparison shopping or because they read the Endowment's literature—presumably make up the bulk of the 20% enrolled (see Br. in Opp. App. B12-B13).

general finding that the Endowment "set the premium at a level competitive with other insurance on the market" (Pet. App. 4a).

These factual findings, which are really the dispositive factual findings in the case, destroy the predicate of respondents' "dual payment" contention. The Endowment's insurance operation differs from a charity dinner because the insureds who buy the insurance, unlike the diners who "eat rubber chicken" (Resp. Br. 43), get just what they pay for—insurance at fair market retail prices. Although the Endowment is fond of saying that its prices are "higher than necessary" (*id.* at 5, 25), this is only a play on words. Everyone who tries to make a profit, rather than simply cover his costs, charges prices that are "higher than necessary," but this does not mean that the price he charges exceeds the fair market value of what he sells. And although respondent is fond of noting that the New York Bar insurance plan cost less than its own plan did (Br. 11 n.7, 41), that does not mean that the Endowment charged more for its insurance than it was worth; as noted above (at 9), twenty other state bar plans cost more than the Endowment's. Contrary to respondent's theory, a tax-exempt organization need not undersell every other competitor in the marketplace in order to be engaged in a "trade or business." Especially is that so since the Endowment, unlike the New York Bar and most of the Endowment's other competitors, tells its insureds that they can reduce the after-tax cost of its insurance by claiming part of their premium payment as a tax-deductible charitable contribution.

3. Respondents make several other arguments that may be answered more concisely:

a. In our opening brief (at 3-6, 30, 33-35), we explain our view of the economics behind the Endowment's high profits. The Endowment largely avoids tackling the points we make, except in one particular. It says that what



we call its “very valuable, but virtually cost-free, asset—a pool of potential insureds, all ABA members, who have far-above-average mortality and morbidity experience” (*id.* at 33-34)—does not account for more than a tiny measure of its revenues (Resp. Br. 28). It suggests that every underwriter, broker and plan administrator in the country has access to the same pool of insureds, and need pay only \$10,000, the price of obtaining the ABA’s mailing list, for the privilege.

This assertion is insubstantial. An outsider cannot command the loyalty and attention of ABA members the way the Endowment does, not for \$10,000, not for any price. One reason the Endowment’s program succeeds is that ABA members are attached to what a witness called “the substance of the organization” (J.A. 317-318). An outsider would probably have had a hard time getting the ABA’s lawyers even to open and read the solicitation letters that it mailed to them. The individual respondents confirmed that they liked the idea of “participating through [their] professional association” (*id.* at 269-270, 287). Another member was drawn to the program in part because he thought that the ABA “would certainly have the clout to deal with the insurance company” (*id.* at 453). The group policyholder in *Professional Insurance Agents v. Commissioner*, *supra*, was likewise “in a superior position to exploit its own membership list, not only because of its direct access to the members but also because of its position as a trusted and responsible representative of their interests” (78 T.C. 246, 264 (1982)). The Tax Court found there that the association’s endorsement was “a uniquely valuable commodity from the standpoint of an insurance company” (*ibid.*), and the same is true of the Endowment’s endorsement here.

b. Respondent likewise makes little effort to blunt the force of the legislative history on which we rely (see U.S. Br. 19-22). From that legislative history, which deals

with the insurance activities of fraternal beneficiary societies, voluntary employees’ beneficiary associations, and veterans’ groups, it is clear that Congress regarded an exempt organization’s operation of an insurance program as a “trade or business,” even though the business is conducted mainly with members of the organization. Respondent offers no analysis of this legislative history; it simply asserts that it has “no relevance to the factual setting of this case” (Resp. Br. 31). And the only ground respondent tenders for labeling this legislative history irrelevant is the assertion that “the legislative history has never before been advanced [by the government] in the long administrative and judicial history of the case” (*id.* at 30).

Respondent’s argument is meritless. In the first place, we did rely on this legislative history in the court below (C.A. Br. 39 & n.28 (citing S. Rep. 91-552, *supra*, at 68)). Even if we had not previously relied upon it, we would be free—indeed, we would be obliged—to bring pertinent legislative history to this Court’s attention now. And this legislative history is quite pertinent indeed. The tax-exempt groups that Congress discussed had available to them the very same argument that the Endowment makes here—that they sold insurance exclusively to their members and thus “depend[ed] on the consent of their customers for [their] profits” (Pet. App. 41a). In describing the insurance activities of those membership groups as a “business[],” Congress indicated that the notion of a “group gift” has no place in the legal analysis required by Section 513(c). See H.R. Rep. 91-413, *supra*, at 47; S. Rep. 91-552, *supra*, at 68.

c. On the charitable contribution issue, the individual respondents seem to accept, almost verbatim, our statement of the controlling legal standard. Compare U.S. Br. 40-43 with Resp. Br. 39-40. Their sole contention is that they bore their burden of proving that the price they

paid for the insurance far exceeded the fair market retail value of the coverage they purchased. See Resp. Br. 41-43. As we showed in our opening brief (U.S. Br. 43-47), and as we have reiterated above (at 8-11), this is precisely what the Claims Court correctly held that respondents had failed to prove.

d. The Endowment properly emphasizes its significant and longstanding accomplishments in the field of legal education (Resp. Br. 6-7 & n.4, 37). We applaud these efforts. The fact that a charity does good, however, is not inconsistent with the requirement—a requirement that Congress imposed in 1950—that it pay income tax when it finances its good works by operating an unrelated “trade or business.” We think that the Endowment’s insurance activities amount to a “trade or business” under the statutory standards that Congress has enacted.

#### CONCLUSION

For these reasons and those set forth in our opening brief, the judgment of the court of appeals should be reversed, and the cases should be remanded to that court with instructions to reverse the Claims Court’s judgment in the Endowment’s case and to affirm the Claims Court’s judgment in the cases of the individual respondents.

Respectfully submitted,

CHARLES FRIED  
*Solicitor General*

APRIL 1986

**MOTION FILED**  
**MAR 10 1985**

(7)

No. 85-599

# In the Supreme Court

OF THE

**United States**

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,  
*Petitioner,*

VS.

AMERICAN BAR ENDOWMENT, et al.,  
*Respondents.*

On Writ of Certiorari to the  
United States Court of Appeals for the Federal Circuit

**MOTION OF  
CALIFORNIA FARM BUREAU FEDERATION  
FOR LEAVE TO FILE BRIEF AMICUS CURIAE,  
AND BRIEF AMICUS CURIAE  
IN SUPPORT OF RESPONDENTS**

THOMAS F. OLSON  
Counsel of Record

CARL G. BORDEN  
1601 Exposition Boulevard  
Sacramento, CA 95815-5195  
Telephone No. (916) 924-4035  
*Attorneys for Amicus Curiae  
California Farm Bureau  
Federation*

10/1/85



## TABLE OF CONTENTS

	<u>Page</u>
Motion of California Farm Bureau Federation for leave to file brief <i>amicus curiae</i> in support of respondents .....	1
Interest of California Farm Bureau Federation .....	1
Summary of the brief <i>amicus curiae</i> .....	2
Reasons for granting this motion .....	3
Brief <i>amicus curiae</i> of California Farm Bureau Federation in support of respondents .....	4
Interest of <i>amicus curiae</i> and summary of argument .....	4
Argument .....	5
I	
Providing group insurance programs to their members is a key purpose of California Farm Bureau Federation and other nonprofit organizations .....	5
II	
The Court should not address the peripheral issue regarding the relation of the activity to the organization's tax-exempt purposes .....	10
Conclusion .....	12

## TABLE OF AUTHORITIES CITED

## Cases

## Page

American Bar Endowment v. United States, 761 F.2d 1573 (Fed. Cir. 1985) .....	10
--	----

## Statutes

I.R.C.	
§ 501(c) .....	11
§ 501(c)(5) .....	2
§ 501(c)(8) .....	11
§ 501(c)(9) .....	11
§§ 511 through 513 .....	2
§ 512(a)(4) .....	11
CAL. INS. CODE (Deering)	
§ 11656.5 .....	6, 10
§ 11656.6 .....	6

## Regulations

Tit. 10, CAL. ADMIN. CODE § 2508 .....	7
--	---

## Other Authorities

Brief of the United States .....	11
California Farm Bureau Federation Articles of Incorporation, Art. II .....	5
California Farm Bureau Federation Bylaws	
Art. I .....	5
Art. XI, § 1 .....	5, 9

## In the Supreme Court

OF THE

United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,  
*Petitioner,*

VS.

AMERICAN BAR ENDOWMENT, et al.,  
*Respondents.*

On Writ of Certiorari to the  
United States Court of Appeals for the Federal Circuit

MOTION OF  
CALIFORNIA FARM BUREAU FEDERATION  
FOR LEAVE TO FILE BRIEF AMICUS CURIAE  
IN SUPPORT OF RESPONDENTS

California Farm Bureau Federation respectfully moves the Court for leave to file the accompanying brief *amicus curiae* in support of Respondents' position in this case.

INTEREST OF  
CALIFORNIA FARM BUREAU FEDERATION

California Farm Bureau Federation is a voluntary, non-governmental, nonprofit California corporation. Its primary purpose is to protect and foster agricultural interests throughout the State of California. Its members consist of 53 county Farm Bureaus with a combined membership at the close of its 1985 membership year

of over 98,000 families. Over 85% of all commercial farmers in the State of California are members of county Farm Bureaus.

At all times since August 29, 1930, California Farm Bureau Federation has been exempt from taxation under I.R.C. § 501(c)(5) and its predecessors as an agricultural organization. As such, California Farm Bureau Federation seeks the Court's permission to express its view in this case because the Court's disposition of a central question herein could have a significant impact on the operation of two important group insurance programs which it offers to members of its member county Farm Bureaus; those programs involve workers' compensation insurance and health insurance. That central question, of course, is whether proceeds realized by a tax-exempt organization from its group insurance activities constitute unrelated business income subject to taxation under I.R.C. §§ 511 through 513.

#### SUMMARY OF THE BRIEF AMICUS CURIAE

The accompanying brief *amicus curiae* summarizes the manner in which the workers' compensation and health insurance programs of California Farm Bureau Federation are operated and discusses the importance of these programs to it, its member county Farm Bureaus and their member families.

The brief *amicus curiae* also discusses a key difference between respondent American Bar Endowment's group life insurance program and the workers' compensation insurance program of California Farm Bureau Federation. That difference pertains to the relation of each organization's group insurance activities to their respective tax-exempt purposes. The American Bar Endowment evidently has conceded that its group insurance activities are not substantially related to its tax-exempt purposes, whereas the group workers' compensation insurance activities of California Farm Bureau Federation are an integral part of its *raison d'etre*. The brief *amicus curiae* thus urges that the Court not address this peripheral issue in the case at bar.

Respondent refused its consent to the filing of the accompanying brief *amicus curiae*.

#### REASONS FOR GRANTING THIS MOTION

California Farm Bureau Federation is only one of perhaps thousands of nonprofit organizations which engage in group insurance activities for the benefit of their members. Its own group insurance activities are probably typical of those of many other nonprofit organizations.

California Farm Bureau Federation believes that the Court should be apprised of the nature, operations and importance of its group insurance programs, so that the Court may understand the impact which its decision in the case at bar might have on these programs, as well as on the countless similar programs operated by other nonprofit organizations throughout the country.

Moreover, California Farm Bureau Federation points out for the Court that at least some group insurance programs sponsored by nonprofit organizations, including its own, are substantially related to the tax-exempt purposes of those organizations. California Farm Bureau Federation believes that the Court should conclude that it should not address this peripheral issue in the instant case, but should defer it for adjudication, if necessary, upon a fully developed record and briefing by an organization to which it is of the greatest importance.

WHEREFORE, California Farm Bureau Federation respectfully moves the Court for leave to file the accompanying brief *amicus curiae*.

Respectfully submitted,

THOMAS F. OLSON

Counsel of Record

CARL G. BORDEN

1601 Exposition Boulevard

Sacramento, CA 95815-5195

Telephone No. (916) 924-4035

*Attorneys for Amicus Curiae*

*California Farm Bureau  
Federation*

By THOMAS F. OLSON



# In the Supreme Court

OF THE  
United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,  
*Petitioner,*

VS.

AMERICAN BAR ENDOWMENT, et al.,  
*Respondents.*

On Writ of Certiorari to the  
United States Court of Appeals for the Federal Circuit

## BRIEF AMICUS CURIAE OF CALIFORNIA FARM BUREAU FEDERATION IN SUPPORT OF RESPONDENTS

California Farm Bureau Federation respectfully submits this brief *amicus curiae* in support of Respondents' position in this case.

### INTEREST OF AMICUS CURIAE AND SUMMARY OF ARGUMENT

A statement describing California Farm Bureau Federation and its interest in this case is set forth in the preceding motion requesting leave to file this brief *amicus curiae*. Likewise, a summary of the following argument is set forth in the preceding motion under the heading "Summary of the Brief *Amicus Curiae*."

## ARGUMENT

### I

#### PROVIDING GROUP INSURANCE PROGRAMS TO THEIR MEMBERS IS A KEY PURPOSE OF CALIFOR- NIA FARM BUREAU FEDERATION AND OTHER NON- PROFIT ORGANIZATIONS

The purposes of California Farm Bureau Federation, as set forth in its Articles of Incorporation and Bylaws, include the following:

- (a) To work for the solution of the problems of the farm, the farm home, and the rural community, by use of the recognized advantages of organized action, to the end that those engaged in the various branches of agriculture may have opportunity for happiness and prosperity in their work.
- (b) To represent, protect, and advance the social, economic and educational interests of the farmers of California.

Articles of Incorporation, Art. II; Bylaws, Art. I.

In addition, the Bylaws of California Farm Bureau Federation provide for the creation of a Rural Health Department as an integral part of the corporation. The California Farm Bureau Rural Health Department has been organized:

- (a) To establish working relationships between county medical societies, rural and public health committees and County Farm Bureau Rural Health Departments.
- (b) To work with the health care and social problems of the retired and disabled of the community.
- (c) To work with groups or agencies providing emergency medical services and distribution of health manpower.
- (d) To help County Farm Bureau Rural Health Departments develop a program of work to meet local health and safety needs.
- (e) To work with the health systems agencies at the county, regional and state levels.
- (f) To sponsor health insurance plans and programs.

Bylaws Art. XI, § 1.

California Farm Bureau Federation is the master policyholder for individual members of its member county Farm Bureaus who choose to participate in a workers' compensation insurance program offered by the State Compensation Insurance Fund. As master policyholder, California Farm Bureau Federation guarantees the payment to the State Compensation Insurance Fund of the insurance premiums payable by its participating members. The State Compensation Insurance Fund sells the policies, bills and collects the premiums, processes claims, and provides calculations for distribution of the annual dividend, if any. These dividends constitute a rebate of premiums based on the experience rating and safety record of the master policyholder and members of its member county Farm Bureaus participating in the program.

As master policyholder, California Farm Bureau Federation receives the annual dividend from the State Compensation Insurance Fund. Amounts received as dividends are then distributed to the various county Farm Bureaus (approximately 1.0% of net dividends) to cover their administrative costs, and to their individual members who participate in the program. California Farm Bureau Federation retains a small percentage of the dividend to cover its expenses in administering the program as master policyholder.

The workers' compensation insurance program in which California Farm Bureau Federation has participated for many years is one which is governed by California statutes and administrative regulations. CAL. INS. CODE § 11656.5 (Deering) ordains such a program for the public purpose of permitting employees of small farms to be brought under the provisions of the workers' compensation insurance law. The Insurance Code provides that employers of agricultural labor who are members of any nonprofit agricultural association may, under such conditions as may be prescribed, be insured under a group workers' compensation insurance policy, provided that the agricultural association guarantees the payment of premiums in respect to all members who are covered under the policy. CAL. INS. CODE § 11656.6 (Deering) provides additional requirements with respect to the issuance

of a workers' compensation insurance policy to an association of employers.

The statutory framework set forth above discloses the fact that California Farm Bureau Federation could not participate in this statutory scheme unless it were to (a) act as master policyholder and (b) guarantee the payment of all premiums payable by the insured agricultural employers. Also, the insured agricultural employers could not participate in the statutory scheme unless they were insured under the master policy of California Farm Bureau Federation or the master policy of some other nonprofit agricultural association. Clearly, in order for California Farm Bureau Federation to be true to its purposes of advancing the interests of California farmers through the use of organized action, it was incumbent upon it to sponsor this group insurance program. This, then, is the principal and dominant motive behind the participation of California Farm Bureau Federation in the workers' compensation insurance program. The recognition of any income as a result of its participation in the program is merely incidental, as shown below.

As mentioned earlier, the group workers' compensation insurance program offered by the State Compensation Insurance Fund is highly regulated by California statutes and regulations. One such rule is contained in tit. 10, CAL. ADMIN. CODE § 2508. It requires the articles of incorporation, bylaws, agreements of association, or other rules and regulations filed by a master policyholder to provide that any distribution of funds to any member derived from a dividend shall not be reduced or forfeited except for reasons set forth in the articles of incorporation, bylaws, agreements of association, or rules and regulations of the organization, and no such reduction or forfeiture shall be made unless the reasons for such reduction or forfeiture have been made known to the members by written communication. The effect of this rule, with which California Farm Bureau Federation has complied in all respects, is to make the nonprofit master policyholder a mere trustee of any dividends it retains. As such trustee, California Farm Bureau Federation is required to make known its practices in retaining any dividends distributed to it under the workers' compensation insurance program. Thus, any



dividends retained by it are kept with the full knowledge of the participating members of its member county Farm Bureaus, thereby making these amounts less in the nature of income and more in the nature of contributions from those members to it.

The rules governing the workers' compensation insurance program make it clear that the generation of profit is not the dominant motive behind California Farm Bureau Federation's participation in the program. Any amounts retained by it are kept with the full knowledge of its members who may act together to have such amounts reduced or eliminated. Viewing the program as a whole, it is clear that California Farm Bureau Federation could be compelled to participate in the program as a master policyholder for the benefit of the members of its member county Farm Bureaus regardless of whether any profit were to be gained from its activity. In this context, its activity cannot be termed a "trade or business."

The activity contributes importantly to California Farm Bureau Federation's exempt functions insofar as the program directly promotes rural and agricultural safety programs designed to minimize the danger of injury in farming operations. Thus, this is a group activity which enhances the happiness and prosperity of California farmers and falls within the scope of California Farm Bureau Federation's exempt purposes.

In addition to the workers' compensation insurance program, California Farm Bureau Federation sponsors certain group health and life insurance programs underwritten by CalFarm Life Insurance Company, a separate taxable corporation. Participation in these programs is limited to members of California Farm Bureau Federation's member county Farm Bureaus, their families and workers. California Farm Bureau Federation collects from those members the premiums due under the plans. These amounts are then remitted to CalFarm Life Insurance Company, less 2.2 percent of the estimated gross monthly premiums. California Farm Bureau Federation retains this 2.2 percent of estimated gross premiums under an agreement with CalFarm Life Insurance Company which specifically limits the amounts to be received by California Farm Bureau Federation to those sufficient to cover its costs in collecting the premiums and performing

certain related administrative functions with respect to the programs. California Farm Bureau Federation has undertaken its health and life insurance activities without any intention to produce, or even to generate a right to receive, any "income" or "profit." The 2.2 percent of gross premiums measure is obviously intended to be a rough approximation of costs that may, over any particular period, be greater or less than actual costs, as measured by a refined accounting system. If this rough approximation proves to be incorrect over time, the parties have agreed to adjust the rate to cover only California Farm Bureau Federation's costs.

The Bylaws of California Farm Bureau Federation, *supra*, provide that the betterment of the conditions of those engaged in agricultural pursuits is one of its purposes, as is the protection and advancement of the economic interests of farmers of California, and that these interests are to be pursued through the use of the recognized advantages of organized action. In addition, California Farm Bureau Federation's Bylaws specifically acknowledge that a California Farm Bureau Rural Health Department shall be an integral part of the corporation and shall be organized for the purpose of sponsoring rural health programs, including health insurance plans and programs. Bylaws, Art. XI, § 1.

From the plain meaning of the words of the Bylaws of California Farm Bureau Federation, it is evident that the purposes for which it has been granted exemption from tax include its sponsorship of organized activities that will further the economic interests of California farmers. There can be no doubt that California Farm Bureau Federation's sponsorship and coordination of the life and health insurance programs made available to its members fall within this category. The offering of group insurance benefits to its members, many of whom are self-employed and therefore not eligible to participate in some group insurance plans, is clearly consistent with and substantially related to the stated purposes of California Farm Bureau Federation.

California Farm Bureau Federation believes that adoption by the Court of the position urged by the United States in the case at bar could result in an enormous burden on it if the Court's decision were to cause incidental income received by it from its sponsorship of these group insurance programs to be taxable as



unrelated business income. Likewise, California Farm Bureau Federation believes that the group insurance programs sponsored by many other nonprofit organizations throughout the country in furtherance of their tax-exempt purposes could be jeopardized or, at the least, unfairly taxed, if the Court were to reverse the decision of the court below.

## II

### THE COURT SHOULD NOT ADDRESS THE PERIPHERAL ISSUE REGARDING THE RELATION OF THE ACTIVITY TO THE ORGANIZATION'S TAX-EXEMPT PURPOSES

The arguments raised by the United States in this case, if accepted without qualification, would permit a holding which fails to recognize the particular circumstances of California Farm Bureau Federation and similar agricultural associations which sponsor workers' compensation insurance programs.

In the present case the American Bar Endowment evidently has conceded that its group insurance activities are not substantially related to its tax-exempt purposes. *American Bar Endowment v. United States*, 761 F.2d 1573, 1576 (Fed. Cir. 1985). This is not true of the workers' compensation insurance program of California Farm Bureau Federation.

As explained *supra*, CAL. INS. CODE § 11656.5 *et seq.* (Deering) provides that members of any non-public agricultural association may be insured under a group workers' compensation policy, provided that certain requirements are met. The purpose and effect of this provision is to make such insurance available to small farmers with few employees, and the implementation of this goal has been a principal purpose of California Farm Bureau Federation for many years.

Administrative regulations and practice have integrated California Farm Bureau Federation with the accomplishment of this public policy. For example, from the inception of the State Compensation Insurance Fund, its Board of Directors has usually

included a current officer of the California Farm Bureau Federation. Often, this has been its President.

These are, in brief, the particular circumstances which, as stated above, might be ignored if a principal argument made by the United States in the present case were accepted without qualification, and we respectfully urge the Court not to do so.

The argument in question begins with the proposition that insurance activities constitute a trade or business and includes the suggestion that unless such activities are listed in I.R.C. § 501(c) as one of the tax-exempt purposes permitted to a specific kind of organization, the activities are taxable. Brief for the United States at 21.

Thus, the United States notes that fraternal beneficiary societies (I.R.C. § 501(c)(8)) and voluntary employees' societies (I.R.C. § 501(c)(9)) are authorized to provide for life, sickness, accident and other benefits to members. The United States acknowledges that income from such activities is not taxable to these organizations because it is substantially related to their tax-exempt purposes.

The same conclusion should follow even if the tax-exempt purpose is not specifically set forth in I.R.C. § 501(c) but instead is part of a state statutory program, such as the California Farm Bureau Federation's participation in California's workers' compensation insurance program.

The United States, however, suggests an opposite conclusion in its Brief, pointing out that because veterans' organizations were not similarly identified in I.R.C. § 501(c) prior to a statutory amendment in 1972, they "lacked any obvious basis for contending that their insurance operations were 'substantially related' to their exempt functions." Brief of the United States at 21.

The statement quoted above would not by its literal terms preclude California Farm Bureau Federation from establishing that it had an "obvious basis" for contending that its insurance operations were substantially related to its exempt function. However, the United States goes on to argue (*Id.* at 24) that the retroactive amendment of I.R.C. § 512(a)(4) in 1972 shows a

Congressional intent to preclude an organization such as California Farm Bureau Federation from establishing its contention.

This argument goes beyond the issues raised in this case and is irrelevant to it because the American Bar Endowment evidently has conceded that its insurance activities are not substantially related to its tax-exempt purposes. However, the issue is essential to California Farm Bureau Federation in its presently pending controversy with the Internal Revenue Service regarding unrelated business income.

We respectfully submit that the Court should not address this peripheral issue in the present case but should defer it for adjudication, if necessary, upon a fully developed record and briefing by an organization to which it is of the greatest importance.

## CONCLUSION

In the case at bar, the United States Court of Appeals for the Federal Circuit correctly held that dividends on a group life insurance policy which insurance carriers had refunded to respondent American Bar Endowment and which it kept pursuant to assignment by its participating members do not constitute taxable unrelated business income. A contrary holding by this Court would greatly harm a multitude of worthwhile group insurance programs operated by nonprofit organizations throughout the country, including those of *amicus curiae* California Farm Bureau Federation.

WHEREFORE, California Farm Bureau Federation respectfully prays that the Court affirm the judgment below.

Respectfully submitted,

THOMAS F. OLSON

Counsel of Record

CARL G. BORDEN

1601 Exposition Boulevard

Sacramento, California 95815-5195

Telephone: (916) 924-4035

*Attorneys for Amicus Curiae*

*California Farm*

*Bureau Federation*